The Taxation of Corporate Groups under the Enterprise Doctrine: A Comparative Study of Eight Consolidation Regimes

Antony Ka Fai Ting
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The Taxation of Corporate Groups under the Enterprise Doctrine: A Comparative Study of Eight Consolidation Regimes

Antony Ka Fai Ting

Thesis submitted in fulfilment of the requirements of the degree of Doctor of Philosophy

September 2011
Sydney Law School, University of Sydney
ABSTRACT

Income tax law in general treats a company as a separate taxable unit, reflecting the traditional separate entity doctrine. However, the rise of corporate groups in the last century poses a serious challenge to the doctrine and demands a paradigm shift. The tax consolidation regime is an increasingly common response of the tax law to the challenge, representing an application of the enterprise doctrine under which a corporate group is treated as one single taxable unit. This thesis aims to improve understanding of the design and implementation of consolidation regimes by undertaking a comparative study of the consolidation regimes in eight countries, namely Australia, France, Italy, Japan, the Netherlands, New Zealand, Spain and the United States. The eight countries are all the countries in the world that, by the end of 2009, have introduced a consolidation regime in their income tax systems.

This thesis analyses and compares alternative policy options adopted in the eight countries for the key structural elements of a consolidation regime, with the intention of searching for a model regime. The comparative analysis also aims to answer the following tax policy question: does a stronger application of the enterprise doctrine necessarily imply a better consolidation regime on policy grounds?

This thesis provides the first comprehensive comparative analysis of the consolidation regimes in the eight countries. The comparison and evaluation of the alternative policy solutions for the key structural elements aims to advance knowledge and improve understanding of the application of the enterprise doctrine in consolidation regimes in practice. The findings of this study should be useful for tax policy makers to design a new consolidation regime, as well as to refine existing consolidation regimes.
ACKNOWLEDGEMENTS

I am forever indebted to Professor Richard Vann, my supervisor, without whose mentorship and inspiration this thesis would have never been completed. His patience with my mistakes, generosity of time reading my drafts, and the numerous meetings and discussions are gratefully acknowledged. I am also grateful to Professor Graeme Cooper, my associate supervisor, for his continuous support and valuable comments on the draft thesis.

My research interest in consolidation regimes was inspired by a lecture delivered by Peter Harris, to whom I acknowledge my gratitude.

I am deeply grateful for the critiques and comments of Cynthia Coleman and Daniel Ho on earlier drafts of the thesis.

Finally, I would like to thank Florence and Joanne Ting for their support, encouragement and forbearance over the past few years.
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<td>Bloc group</td>
<td>A corporate group consisting of group members resident in a bloc of participating countries</td>
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<td>Consolidation</td>
<td>A group taxation regime under which a corporate group files a consolidated tax return, allowing <em>both</em> intra-group loss offset and tax free intra-group asset transfer</td>
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<tr>
<td>Country group</td>
<td>A corporate group consisting of group members resident in a country</td>
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<tr>
<td>De-consolidation</td>
<td>The incidence of a consolidated group ceasing consolidation and every group member is treated as a separate taxpayer again</td>
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<tr>
<td>Enterprise doctrine</td>
<td>The doctrine under which a corporate group under the common control of a parent company is treated as a single enterprise</td>
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<td>Head company</td>
<td>The parent company in a consolidated group</td>
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<td>Intra-group asset transfer</td>
<td>The tax attribute of a group taxation regime that allows tax free transfer of assets within a corporate group without the need of a corporate restructure</td>
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<tr>
<td>Joining time</td>
<td>The time when a subsidiary joins a consolidated group</td>
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<tr>
<td>Leaving time</td>
<td>The time when a subsidiary leaves a consolidated group</td>
</tr>
<tr>
<td>Separate entity doctrine</td>
<td>The doctrine under which a company is treated as a separate entity, distinct from its shareholder(s)</td>
</tr>
<tr>
<td>Subsidiary member</td>
<td>A member of a consolidated group other than the head company</td>
</tr>
<tr>
<td>Taxable income</td>
<td>The net income of a taxpayer computed under the tax law after deducting allowable expenses</td>
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Worldwide group  A corporate group consisting of all group members in the world
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<td>North American Free Trade Agreement</td>
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<td>NZ</td>
<td>New Zealand</td>
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<td>OECD</td>
<td>Organisation of Economic Cooperation and Development</td>
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<td>PE</td>
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1.1 Introduction

Income tax law in general treats a company as a separate taxable unit, reflecting the traditional separate entity doctrine. The rise of corporate groups in the last century poses a serious challenge to the doctrine. A tax consolidation regime is an increasingly common response of the tax law to the changing paradigm, representing an application of the enterprise doctrine under which a corporate group is treated as one single taxable unit. This thesis aims to improve understanding of the design and implementation of a consolidation regime by comparing alternative policy options for the key structural elements, with the intention of searching for a model consolidation regime.

This chapter first provides an overview of the rise of corporate groups which
challenges the traditional separate entity doctrine. It then describes the development of tax consolidation regimes as a comprehensive response of the tax law to the challenge. The chapter then explains the aims and significance of this thesis, and outlines the research methodology. It concludes with the structure of this thesis and a summary of the ensuing chapters.

1.2 The rise of corporate groups

Corporate groups are very significant and influential players in the modern commercial world. Many businesses, especially large and multinational enterprises, are conducted not by a single company but by a corporate group under the common control of a parent company. A report prepared by the United Nations showed that the sales of the top 200 multinational firms accounted for 27.5 per cent of world gross domestic product ("GDP") in 1999.\(^1\) Of the 50 largest "economies", 14 were multinational corporate groups and 36 were countries. Furthermore, the sizes of multinational corporate groups have been growing at rates exceeding those of many economies. For example, the sales of the 500 largest firms in the world nearly tripled between 1990 and 2001, while the world GDP increased only 1.5 times in the same period.

Corporate group structures are very popular. For instance, an empirical study in Australia demonstrated that nearly 90 per cent of top listed companies (by market capitalisation) had at least one controlled entity.\(^2\) On average, each listed company had 28 controlled entities, 90 per cent of which were wholly


\(^2\) Ian M Ramsay and G Stapledon, "Corporate Groups in Australia" (2001) 29(1) *Australian Business Law Review* 7, at 8
owned subsidiaries.  

Why have corporate groups become more common in the modern business world? Several reasons have been commonly put forward. First, limited liability of a company ensures that, subject to exceptions where the corporate veil is lifted, the assets of a parent company are shielded from claims by the creditors of its subsidiary. Second, by incorporating subsidiaries in tax havens, profits of a corporate group may be shielded from the reach of tax authorities in the home countries of the parent company and other fellow subsidiaries. For example, an empirical study shows that about 1.4 per cent of controlled entities of top 50 listed companies in Australia were incorporated in three well-known tax havens: the British Virgin Islands, Cayman Islands and Bermuda. Third, it is common and convenient to structure the acquisition of a business in the form of shareholdings in a new investment vehicle, usually a company.

1.3 Tension between traditional legal principle and commercial reality

Corporation law evolved from a world where corporate groups did not exist. Before the 19th century, companies were formed under charter with individuals as shareholders. Corporate structures involved only two levels: individual shareholders and their companies. This was the time when the separate entity doctrine — under which a company is treated as a separate entity — was developed. In the late 19th century, the very nature of the business structure experienced a “revolutionary change”: holding companies

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3 Ibid, at 9.
5 For more discussion of the issue, see Chapter 2 Section 2.2.
The rise of corporate groups poses a serious challenge to the traditional separate entity doctrine. The economic substance of a corporate group creates tensions between the separate entity doctrine and commercial reality. A corporate group under the common control of a parent company often operates as one single economic enterprise. In practice, senior management of a corporate group, and creditors dealing with companies within the group, often focus on the group as a whole instead of on individual companies. This raises the question of whether the law should recognise the commercial reality and extend the rights and duties of a company within a group to reflect the activities of other group members. Blumberg describes this issue as “one of the major problems in corporation law”. He argues that the traditional separate legal entity principle is not relevant to the powerful corporate groups in the modern commercial world.

Corporation law in the United States (and in other countries as well) is breaking down because of the increasing tension between the conventional view of each corporation as a separate legal entity, irrespective of its interrelationships with its affiliated corporations ... and the economic reality of a complex industrial society overwhelmingly conducted by corporate groups: parent companies, sub-holding companies, and innumerable subsidiary companies collectively conducting worldwide integrated enterprises. The predominance of such powerful multinational corporate complexes is creating irresistible


8 Ibid, at 285.
pressure for the development of new legal concepts to impose more effective societal controls than those available under traditional entity law reflecting the society of centuries ago ... The extensive discussion of the nature of the corporate personality in the United States, a preoccupation of legal scholars for more than a century, has become increasingly irrelevant ...

Over the past century, courts and legislatures, in resolving the legal questions before them, have been increasingly faced with the difficult choice between focusing on the individual corporate entity or the business enterprise as a whole.9

The modern commercial world dictates a change of paradigm with respect to certain aspects of corporation law. Instead of a universal adoption of the separate entity principle, a growing number of areas in corporation law are being supplemented by the doctrine of “enterprise law”.10 The enterprise doctrine focuses on the business enterprise as a whole, instead of its fragmented components. Under this doctrine, the economic substance overrides the legal form of individual companies that make up the corporate groups.

This raises the question of whether the enterprise doctrine has a similar role to play in tax law. The following section describes the responses of the tax law to the challenge posed by the rise of corporate groups.

9 Blumberg, above note 6, at 606.

10 Ibid, at 605. For a detailed discussion of the enterprise doctrine in the context of corporation law, see Phillip I Blumberg, The Multinational Challenge to Corporation Law: The Search for a New Corporate Personality (New York, Oxford University Press, 1993), at 231-253. The application of the doctrine in tax law is discussed in more detail in Chapter 2 Sections 2.3.2 and 2.3.3.
1.4 Tax consolidation: a response to the rise of corporate groups

In general, tax law adopts the separate entity doctrine and treats a company as a separate taxpayer. This raises the question of how the tax law should respond to the changing paradigm imposed by the rise of corporate groups. So far, the responses of the governments have been ad hoc and inconsistent. The different group taxation regimes in the world represent a spectrum of varying degrees of application of the enterprise doctrine, ranging from the relatively restrictive group loss relief regimes to the more comprehensive consolidation regimes.

In this thesis, the term “consolidation” refers to a full consolidation regime under which a group of resident companies is in general treated as one single taxpayer and files a consolidated tax return, allowing both intra-group loss offset and tax free asset transfers. The term “consolidation” may mean different types of regimes in different contexts. It may be used to include other group taxation regimes, such as the group loss relief in the U.K. and Organschaft in Germany. The term “consolidation” has even been used to cover virtually all forms of group taxation regimes.

Consolidation is an increasingly common response of the tax law to the rise of

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12 Italy is included in the comparative study in this thesis because, when its domestic consolidation regime was first introduced in 2004, it satisfied the definition of “consolidation” for the purpose of this thesis. In particular, it allowed tax free intra-group asset transfers among consolidated group members. However, this policy was abolished in 2008. For more detail of the policy change, see Chapter 7 Section 7.3.


14 For example, see Ernst & Young, *Barometer of tax competitiveness for 2009* (available at www.ey.com), accessed on 28 May 2010.
Chapter 1 Introduction

corporate groups. The introduction of a consolidation regime is often a major tax reform of the income tax system in a country, fundamentally changing the taxation of corporate groups. Consolidation regimes are likely to become more popular for a number of reasons. First, the international trend shows an increasing number of countries adopting consolidation in recent years. While some countries have had a consolidation regime for many decades – namely, the U.S. (1917), the Netherlands (1940), France (1971) and Spain (1977) – five countries have adopted a consolidation regime in the past two decades, namely New Zealand (1992), Australia and Japan (2002), Italy (2004), and South Korea (2010). As more countries introduce consolidation regimes in their tax systems, other countries tend to be under more pressure – especially with the lobbying effort of businesses – to follow suit. In fact, many countries have introduced a consolidation regime to promote this policy objective. For example, all of the three most recent consolidation regimes – namely, in Italy, Japan and South Korea – were introduced with a clear objective to promote competitiveness. Second, two countries – namely Australia and New Zealand – introduced a consolidation regime, despite already having a group


loss relief regime. For instance, Australia introduced its consolidation regime in 2002 largely to replace the existing regimes for intra-group loss offset and asset transfers partly due to the complexity arising from those existing group taxation regimes. It is reasonable to expect that some countries already equipped with other group taxation regimes may follow suit and introduce a consolidation regime.

1.5 The thesis
1.5.1 Aims of the research
This research project provides, to the author’s knowledge, the first comprehensive comparative analysis of the consolidation regimes in eight countries: Australia, France, Italy, Japan, the Netherlands, New Zealand, Spain and the United States. They are the eight countries that, by the end of 2009, have introduced consolidation regimes in their income tax systems.

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18 South Korea introduced a consolidation regime in 2010: IBFD, “Asia Pacific – Taxation and Investment Database – Country Analysis – Republic of Korea (online database)” (available at www.ibfd.org), accessed on 30 April 2010. However, as little information is available on its detailed rules and actual implementation, it is not analysed in detail in this thesis. Canada had a consolidation regime from 1932 to 1952. For a brief discussion of the regime, see Stephen Richardson, “Transfers of deductions, credits, or losses within corporate groups: a Department of Finance perspective” in Canadian Tax Foundation, Report of Proceedings of the Thirty-sixth Tax Conference (“CTF 1984 Conference Report”) (1985, Canadian Tax Foundation, Toronto), at 738-739. The regime was similar to the U.S. counterpart, but much simpler: at the time of its repeal, the regime was “contained in one section of 11 subsections”: ibid, at 739; see also Robert Couzin, “Income taxation of groups of corporations: the case for consolidation” in CTF 1984 Conference Report, at 719. The government’s rationale for repealing the regime was that the introduction of the general business loss carryover rules had made the consolidation regime unnecessary, but the justification was not very convincing to many commentators: see for example Stephen Richardson, “A Corporate Loss Transfer System for Canada: Analysis of Proposals” in Canadian Tax Foundation, Report of Proceedings of the Thirty-seventh Tax Conference (1986, Canadian Tax Foundation, Toronto), at 12:2; and Couzin, ibid, at 720.
Table 1 Years of introduction of consolidation regimes

<table>
<thead>
<tr>
<th>Year of Introduction</th>
<th>Country</th>
</tr>
</thead>
<tbody>
<tr>
<td>1917</td>
<td>The United States</td>
</tr>
<tr>
<td>1940</td>
<td>Netherlands</td>
</tr>
<tr>
<td>1942</td>
<td>Spain</td>
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<tr>
<td>1971</td>
<td>France</td>
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<td>1993</td>
<td>New Zealand</td>
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<td>2002</td>
<td>Japan</td>
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<tr>
<td>2002</td>
<td>Australia</td>
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<tr>
<td>2004</td>
<td>Italy</td>
</tr>
<tr>
<td>2010</td>
<td>South Korea</td>
</tr>
</tbody>
</table>

The two main objectives of the comparative analysis are:

(1) Comparison of alternative policy solutions:
The comparative study identifies the key structural elements of a consolidation regime, and the respective alternative policy solutions adopted in the eight countries. The alternative policy options are compared and evaluated critically against generally accepted tax policy objectives including simplicity, neutrality and competitiveness.

(2) Search for a model consolidation regime:
The comparative study also intends to search for a model consolidation regime, representing the best practice in respect of the key structural elements on policy grounds. The model regime should be of particular interest to countries considering the introduction of a consolidation regime.

1.5.2 Significance of the comparative study
The comparative study of the consolidation regimes in the eight countries
Chapter 1 Introduction

compares and evaluates the alternative policy options for the key structural elements of a consolidation regime, thus seeking to improve the understanding of the design and implementation of the regime.

It is important for tax policy makers in a country to be aware of the policy solutions adopted in other countries.\(^\text{19}\) This is useful not only for the eight countries which may need to fine-tune their existing consolidation regimes, but also for other countries that contemplate the introduction of a consolidation regime. Experience suggests that once a consolidation regime is introduced, there are unlikely to be major structural changes in the regime. Businesses enjoy the benefits of intra-group loss offsets and tax free asset transfers under the consolidation regime. Repeal of the regime is therefore most likely politically unacceptable. Fine-tuning is often the only feasible approach in practice. Therefore, it is important for countries that contemplate the introduction of a consolidation regime to get the legislation right when it is first introduced. Of course, a policy that is effective and appropriate for one country may not be so for another. Transplanting a policy solution from one country to another without due consideration of the local circumstances and constraints can be hazardous.\(^\text{20}\) Nevertheless, important lessons may be learnt from an examination of alternative policy options in other countries.

The comparative analysis serves another purpose. Consolidation regimes in


\(^{20}\) Brian J Arnold, *The Taxation of Controlled Foreign Corporations: An International Comparison* (1986, Canadian Tax Foundation, Toronto), at 406. Transplanting a policy solution without due consideration of local circumstances is dangerous as the policy solution in a country may be the compromise between conflicting policy objectives and political forces particular to that country: “Like the weather, tax is produced by the intersection of powerful competing forces, and a general theoretical explanation of why a particular provision can be found in a particular country at a certain time is often difficult to produce”: Victor Thuronyi, “Tax Law” in Jan M Smits (ed), *Elgar Encyclopedia of Comparative Law* (2006, Edward Elgar, Cheltenham) 709, at 715.
the eight countries apply, to considerably different extents, the enterprise doctrine under which a corporate group is treated as one single taxpayer. The eight regimes represent a spectrum, ranging from the pooling system (for example, in France) – under which each consolidated member remains to a large extent a separate entity for income tax purposes – to the “asset-based” model in Australia, under which all consolidated subsidiaries are effectively deemed to have become divisions of the parent company and ceased to exist for income tax purposes.21 The comparative analysis provides an opportunity to answer the following question: does a stronger application of the enterprise doctrine necessarily imply a better consolidation regime on policy grounds?

The consolidation regime in each of the eight countries has been studied at considerable depth in the respective countries. However, very few comparative research studies have been undertaken for two or more countries.22 Little, if any, has been written on the comparison and evaluation of the consolidation regimes of all the eight countries.23 This thesis aims to fill the gap.

21 Australia’s consolidation regime allows trusts and partnerships to be consolidated members. However, for the purpose of this thesis and to facilitate the comparative analysis with other countries, the discussion focuses on companies.


23 It has been observed that “relatively few [tax] comparative studies are comprehensive in scope”: Thuronyi, above note 20, at 709. The demand for comparative knowledge of tax law is strong not only for policy makers, but also for tax practitioners: ibid.
1.5.3 Methodology

A comparative research methodology is adopted in this thesis. Countries often face similar problems in their income tax systems. It can be helpful for a country to examine other countries’ experience which provides an important source in identifying options for addressing tax policy problems.\(^{24}\) If a policy option is proved to be effective, it may be possible to adopt the same solution in the country, with modifications with respect to the domestic context. Important lessons may also be learnt from other countries’ less successful experience which can help a country to avoid problematic policy options.\(^{25}\)

This comparative study adopts the functional approach which is widely adopted in comparative legal research. Functionalism is the “basic methodological principle of all comparative law”.\(^{26}\) It involves a comparison of the functions of tax rules of different countries with the goal of identifying similarities and differences of domestic tax systems and alternative policy solutions to common problems.\(^{27}\)

In particular, the common core approach is employed to identify the key structural elements of a consolidation regime and to compare the alternative policy solutions for the structural elements. In general, the common core approach of comparative law compares alternative legal solutions to common

\(^{24}\) Arnold, note 19 above, at 18.


core problems. The comparative study in this thesis reflects the law as at 31 December 2010.

The key structural elements of a consolidation regime analysed in this thesis are:

1. The single entity concept;
2. Consolidation of group results;
3. Liability to tax;
4. Election to consolidate;
5. The “all in” rule;
6. Definition of a group;
7. Treatment of pre-consolidation losses;
8. Treatment of consolidated group’s losses;
9. Treatment of assets; and
10. Treatment of intra-group shares.

The first key structural element - the single entity concept - is the fundamental policy underlying a consolidation regime, and often affects the policy options for other structural elements. Therefore, it is analysed first. The second and third key structural elements deal with how a consolidated group computes its taxable income and who is liable to pay the consolidated group’s tax liability. The fourth structural element focuses on whether an

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29 The items in the list may be classified in different ways. For example, the treatment of pre-consolidation losses, and of assets at joining time (that is, when a subsidiary joins a consolidated group) and at leaving time (that is, when a subsidiary leaves a consolidated group), are transitional issues which arise when a company joins or leaves a consolidated group. However, for the purposes of this comparative study, they are listed as shown to facilitate the comparison of related issues. For example, the policy options of assets at joining time, during consolidation and at leaving time are often interrelated and therefore are analysed together.
election to consolidate is revocable or not. The next two structural elements —
the “all in” rule and the definition of a group — determine the composition of a
corporate group that can elect to consolidate. The seventh and eighth key
structural elements deal with the treatments of losses, while the remaining two
structural elements deal with the treatment of assets and intra-group
shareholdings.

These ten core elements form the structural framework of the comparative
analysis in this thesis to evaluate alternative policies adopted in the
consolidation regimes in the eight countries.

1.6 Structure of the thesis
This thesis is divided into three parts. Part One presents a discussion of the
theory of the enterprise doctrine, explains why it is more relevant to the
taxation of corporate groups than the traditional separate entity doctrine, and
provides an overview of the different group taxation regimes representing the
application of the enterprise doctrine in practice. Part Two is the heart of this
thesis: it provides the detailed comparative analysis of the alternative policies
for the ten key structural elements of the eight consolidation regimes. Part
Three explores the possibility of extending the application of the enterprise
document to a multilateral level.

Part One discusses the theory of the enterprise doctrine and reviews the actual
applications of the doctrine in practice in the forms of different group taxation
regimes. Chapter 2 begins with an overview of the traditional separate entity
document and how the rise of corporate groups poses a serious challenge to the
document. This is followed by a discussion of the theory of the enterprise
document and the justifications for its application to the taxation of corporate
groups. The chapter then explores on a theoretical level the possible forms of
application of the doctrine to group taxation and develops a taxonomy of group taxation models. Chapter 3 employs the theoretical framework of applying the doctrine developed in Chapter 2 and reviews how the enterprise doctrine has been applied in group taxation regimes in practice. The purpose of the review is to ascertain the different extents to which the doctrine has been applied in practice, given the constraints imposed on its application in the real world.

Part Two provides a detailed comparative analysis of the key structural elements of consolidation regimes in the eight countries. Chapter 4 reviews the policy objectives of the eight consolidation regimes in order to understand why a country decides to deviate from the traditional separate entity doctrine and apply the enterprise doctrine in a consolidation regime, and compares critically the alternative policy options for the following key structural elements of a consolidation regime: the single entity concept; consolidation of group results; liability to tax; election to consolidate and the “all in” rule. Chapter 5 analyses and compares the definitions of a group under the eight consolidation regimes, which comprise two key elements: entities eligible to join consolidation and the ownership requirements. Chapter 6 provides a detailed analysis and comparison of the treatment of losses in the eight consolidation regimes. The ability of intra-group loss offset is one of the major advantages of consolidation. The analysis covers the treatment of both pre-consolidation losses of a joining subsidiary and net losses of a consolidated group. Chapter 7 analyses and compares the treatment of assets at joining time, during consolidation and at leaving time. Chapter 8 deals specifically with the treatment of intra-group shares in the eight consolidation regimes. Together with the associated dual cost bases issue, the treatment of intra-group shareholdings is one of the most complex issues of a consolidation regime in countries without a general participation exemption regime for domestic corporate groups. Chapter 9 analyses a number of issues arising
from the interactions between consolidation regimes and other parts of the income tax systems, and highlights the inherent tension between the separate entity doctrine and the enterprise doctrine. Chapter 10 concludes Part Two by providing an overall comparison of the eight consolidation regimes with respect to the key structural elements analysed in Chapters 4 to 9, with an intention to search for a model consolidation regime. This Chapter also answers the policy question of whether a stronger application of the enterprise doctrine necessarily implies a better consolidation regime on policy grounds.

Part Three explores the possibility of extending the application of the enterprise doctrine to a multilateral level. Chapter 11 evaluates the feasibility of a multilateral consolidation regime, drawing substantially from the experience of the most recent and ambitious attempt to apply the enterprise doctrine at a multilateral level: the Common Consolidated Corporate Tax Base ("CCCTB") project in the EU. This chapter provides a brief history of the formulary apportionment ("FA") method, reviews the arguments put forward for the multilateral FA model in the past few decades, and analyses the problems of implementing the model in practice in the light of the detailed information available from the CCCTB project.

Chapter 12 concludes this thesis by summarising the findings of the comparative analysis of the eight consolidation regimes, stating the limitations of the research and suggesting future research areas.

1.7 Conclusion
The rise of corporate groups challenges the traditional separate entity doctrine under which a company, despite being a member of a corporate group, is treated as a separate taxable unit. One of the most comprehensive responses of the tax law to the challenge is the introduction of a consolidation regime,
which treats a corporate group as one single taxpayer under the enterprise doctrine. By the end of 2009, eight countries have introduced consolidation regimes, namely Australia, France, Italy, Japan, the Netherlands, New Zealand, Spain and the U.S. This thesis aims to provide a comprehensive comparative analysis of the eight consolidation regimes in respect of ten common key structural elements. The comparative study analyses and evaluates the alternative policy options to deal with the common issues of a consolidation regime, with the intention to identify a model regime. This study is, to the knowledge of the author, the first comprehensive comparative analysis of the consolidation regimes in all the eight countries, and improves understanding of the key issues in the design and implementation of a consolidation regime. The analysis provides useful comparative materials for tax policy makers of the eight countries as well as other countries considering the introduction of a consolidation regime.

The next chapter provides an overview of the traditional separate entity doctrine, discusses the theory of the enterprise doctrine and the justification for its application to the taxation of corporate groups. It then explores on a theoretical level the possible models of application of the doctrine to the taxation of corporate groups.
CHAPTER 2
APPLICATION OF THE ENTERPRISE DOCTRINE
TO THE TAXATION OF CORPORATE GROUPS
- THEORY

2.1 Introduction
This chapter first provides an overview of the traditional separate entity doctrine and describes how the rise of corporate groups poses a serious challenge to the doctrine. This is followed by a discussion of the theory of the enterprise doctrine and the justification for its application to the taxation of corporate groups. The last part of this chapter explores, on a theoretical level, the possible forms of application of the doctrine to group taxation, and develops a taxonomy of group taxation models, setting the stage for the review and classification of its applications in practice in the next chapter.

2.2 The separate entity doctrine
2.2.1 Historical development of legal personality of companies
From its very beginning, corporation law deemed each company to be a separate legal person with its own rights and obligations, separate and distinct from those of its shareholders.\(^1\) In the mid 19\(^{th}\) century, the separate legal entity doctrine was reinforced by the decision of legislatures to provide limited

\(^1\) For an historical summary of the development of the general idea that a company is a fictitious legal person distinct from the actual persons who compose it, see Samuel Williston, “History of the Law of Business Corporations before 1800” (1888) 2(3) Harvard Law Review 105.
liability for shareholders. By then, with the substantial growth of the size of companies and the number of shareholders, the traditional assumption that shareholders were both investors and managers of the company at the same time became increasingly questionable. Many shareholders were solely investors, and did not participate in management. Limited liability was therefore provided to shareholders, insulating them from the financial obligations of the company.

The separate legal personality of companies was firmly established by the end of the 19th century. In the famous Salomon case, it was established that a company was a legal entity separate from its shareholders, even though the company in question was controlled by Mr. Salomon, the sole shareholder of the company. In other words, the corporate veil was firmly drawn.

The separate legal personality, together with the advantage of limited liability, has led to the ever increasing popularity of using companies as vehicles for carrying on businesses. The two attributes are very effective to shield shareholders from claims of the companies’ creditors, thus encouraging more entrepreneurs to engage in businesses which are inherently risky. The courts sometimes ignore this legal fiction of “separate entity” to accommodate other rights and interests. However, there is a lack of consistent underlying doctrine

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3 For a detailed analysis of applying limited liability to corporate groups instead of to closely held companies, see Phillip I Blumberg, “Limited Liability and Corporate Groups” (1986) 11 Journal of Corporation Law 574.


5 For criticism of the case and its legacy of “rigid adherence to entity law in the English-language jurisdictions”, see Blumberg, above note 2, at 154-161.
to support the deviation, as Eustice observed: 6

When departing from the fiction, judicial decisions have cleaved to no single doctrine, to the disappointment of philosophers and the despair of text writers. The diversity of legal approaches found in other branches of the law is well mirrored by the tax law.

2.2.2 Companies as separate taxable units

Though a legal fiction, the separate legal personality of companies is a fundamental building block of the income tax law. A company is in general treated as a separate taxable unit from its shareholders. There are exceptions to the general rule — for example, the controlled foreign company rules — but the separate entity doctrine remains as the dominant principle in corporate tax law.

A fundamental tax policy question is whether a company should be taxed as a separate taxable unit. At a theoretical level, there are arguments on both sides. However, the most convincing argument to tax at the company level is pragmatic in nature. As Couzin explained, "corporations are a convenient place to impose and collect tax on income earned, in economic terms, by their shareholders. Taxing companies prevents deferral . . .". 7 This is sometimes known as the "withholding function" of corporation taxation. In practice, therefore companies in general are treated as a separate taxable unit, representing the application of the separate entity doctrine.

Another reason for levying tax at the company level is that an attribution

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6 James Eustice, Federal Income Taxation of Corporations and Shareholders (2007, RIA) (available at www.Westlaw.com), paragraph 1.05. Though the comment was made in the U.S. context, it is equally applicable to many countries, especially common law countries.

system is in general inappropriate for the taxation of shareholders. In the modern commercial world, many large companies are widely held. Individual shareholders of such a company in most cases do not have any control over the operations or the distribution of profits of the company. The company’s profits do not have direct impact on the ability to pay of its individual shareholders. Attributing the profits to shareholders and levying tax accordingly would therefore violate the fairness principle. Except for closely-held companies, attribution is inappropriate as a taxation system for shareholders in most cases.

2.2.3 The rise of corporate groups: a challenge to the separate entity doctrine

In the late 19th century, the very nature of the business structure experienced a “revolutionary change”. Holding companies started to appear. For instance, in 1890, for the first time companies were allowed to acquire shares of other companies in the U.S. Since then, the size, scope and complexity of corporate groups has grown tremendously. It is not uncommon to have corporate groups with hundreds of companies and complex multi-tiered corporate structures.

In the modern economy, many businesses, especially large and multinational enterprises, are conducted not by a single company but by a corporate group under the common control of a parent company. Over the past century, courts and legislatures have been increasingly faced with the difficulty of choosing between focusing on the individual corporate entity or the business enterprise as a whole.

Corporate groups challenge the traditional separate entity doctrine which treats

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9 Ibid, at 606.
a company as a legal entity separate from its shareholders. The corporation law was originally formulated for the far simpler economy when corporate groups did not exist. As Blumberg observed:10

The traditional corporation law presupposing as its subject the individual corporation and looking upon it as the basic legal unit entity no longer adequately serves all the needs of modern jurisprudence ... While the older entity view still adequately serves many areas, that view no longer prevails as a transcendental concept dominating all corporation law.

In practice, the senior management of a corporate group, and creditors dealing with companies within the group, focus on the group as a whole instead of on individual companies. This leads to the question of whether the law should recognise this commercial reality and treat a corporate group as one enterprise. In the context of tax law, the fact that many countries have specific group taxation regimes suggests that they believe so.

2.3 The enterprise doctrine

2.3.1 Development of the enterprise doctrine in corporation law

The modern commercial world dictates a change of paradigm in respect of certain aspects of corporation law. Instead of a universal adoption of the separate entity doctrine, a growing number of areas in corporation law are being supplemented by the enterprise doctrine.11 The enterprise doctrine focuses on the business enterprise as a whole, instead of on its fragmented components. Under the doctrine, a business enterprise under the common control of a parent company – despite compromising separate legal entities – is treated as one single entity. In other words, the economic substance overrides

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10 Ibid, at 605 & 606.
11 Ibid, at 605.
the legal form of the individual companies that make up the corporate group.

The “business enterprise” concept under corporation law is based on two main factors: control and economic integration. Corporate groups are enterprises organised in the form of a parent company with its subsidiaries under its control. The enterprise doctrine rests on the economic reality that “business activities are collectively conducted by interrelated and intertwined juridical entities under the ‘control’ of a dominant parent corporation.” Corporation law needs the enterprise doctrine to supplement the separate entity doctrine. While the latter continues to function as the “default” doctrine, the enterprise doctrine prevails if it best achieves the underlying policy objectives of the law in the particular area.

The enterprise doctrine is consistent with the economic theory of a firm. In the context of companies and corporate groups, economic analysis focuses on the economic organisation, known as a “firm”, instead of on the legal form that it takes. Coase defined a firm as follows:

A firm ... consists of the system of relationships which comes into existence when the direction of resources is dependent on an entrepreneur.

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12 In contrast, the application of the enterprise doctrine in tax law focuses primarily on the “control” factor, as the “economic integration” factor has proved to be problematic to apply in practice: see discussion in Section 2.3.2 below.
13 Blumberg, above note 8, at 609.
14 See for example Ronald Coase, “The Nature of the Firm” (1937) 4(16) Economica 386, at 390-397. In this classic article, Coase introduced the concept of transaction costs, for which he was awarded the Nobel Prize in Economics in 1991.
15 Ibid, at 393. Coase used the term “entrepreneur” to refer to "the person or persons who, in a competitive system, take the place of the price mechanism in the direction of resources": ibid, at 388, footnote 2.
Coase argued that firms exist because, due to the existence of transaction costs in the market, the allocation of resources can be made more efficient by firms than exclusively by exchanges in the market.\(^{16}\)

Outside the firm, price movements direct production, which is coordinated through a series of exchange transactions on the market. Within a firm, these market transactions are eliminated and in place of the complicated market structure with exchange transactions is substituted the entrepreneur-co-ordinator, who directs production.

A firm, in economic terms, is an organisation under the direction of an entrepreneur. It is not defined in terms of the legal form. A firm can be an incorporated company, or a group of incorporated companies under common control of the entrepreneur.

An important implication of the economic concept of a firm is that it is based on the ability of the entrepreneur to direct resources. In other words, the boundary of a firm is determined by the reach of the control of the entrepreneur over resources. As Coase explained:\(^{17}\)

We can best approach the question of what constitutes a firm in practice by considering the legal relationship normally called that of “master and servant” or “employer and employee” … The master must have the right to control the servant’s work, either personally or by another servant or agent. It is this right of control … which is the dominant characteristic in this relation … We thus see that it is the fact of direction which is the essence of the legal concept of “employer and employee”, just as it was

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\(^{16}\) Ibid, at 388.

\(^{17}\) Ibid, at 404.
in the economic concept [of a firm].

Under the economic perspective, a group of companies may be treated as one single enterprise if the companies are under the control of the same entrepreneur. This is consistent with the enterprise doctrine. Not only is the legal form of a corporate group irrelevant, but also a group is treated as one single entity if subsidiary members in the group are under the common control of a parent company.¹⁸

2.3.2 The enterprise doctrine and the tax law

The key question is how the income tax law should respond to the changing paradigm presented by the rise of corporate groups and whether individual group companies should continue to be treated as separate taxable units, or should the group be treated as one single taxable unit. Under the enterprise doctrine, a corporate group – consisting of a parent company and subsidiaries under its control – should be treated as one single taxable unit. This reflects the economic reality that a group is so economically integrated that it operates like a single entity.¹⁹ So far, the legislative responses and the application of the enterprise doctrine in the income tax law have been ad hoc and inconsistent. Group taxation regimes in the world represent a spectrum of different extents of application of the enterprise doctrine. Policies dealing with group taxation issues vary considerably not only among countries, but also within the same country. A group taxation regime adopted in a country is often a compromise between conflicting policy objectives and constraints.²⁰

¹⁸ The issues of the definition of control are discussed in more detail in Chapter 5 “Definition of a group”.

¹⁹ This is also referred to as the conflict between the legal and economic perspectives. For a discussion of the two perspectives in the context of the relationship between companies and their shareholders, see Peter A Harris, Corporate/Shareholder Income Taxation and Allocating Taxing Rights between Countries (1996, IBFD, Amsterdam), at 42-46.

²⁰ This issue has been described as the destination of “the path of least resistance”: Richard M Bird, “Interjurisdictional allocation of income” (1986) 3(3) Australian Tax Forum 333, at 336.
The application of the enterprise doctrine in the income tax law has a significant feature: its application in practice – especially in respect of the definition of a group – focuses on the concept of control. The issue of whether a group carries on the same business or has sufficient economic integration is irrelevant in most group taxation regimes. In fact, the experience of attempting to define a group in terms of “same business” or “economic integration” in Germany and the U.S. strongly suggests that it is very difficult to implement and police.\(^{21}\) For instance, the U.S. experience suggests that the application of the “same business” principle in practice is very problematic, as “overwhelming problems exist in attempting to define with any degree of precision what constitutes a unitary business” (emphasis added).\(^{22}\) Even proponents of a “unitary business” model admitted that “it is unlikely that a definition of a unitary business can be developed that would solve all cases”.\(^{23}\) For these reasons, discussion of the application of the enterprise doctrine in group taxation regimes focuses on the concept of control, and not on economic integration.\(^{24}\)

### 2.3.3 Why the enterprise doctrine is more appropriate for the taxation of corporate groups


\(^{24}\) For more discussion of the unitary business issue, see Appendix C Section C.2.2.4.
The application of the enterprise doctrine to the taxation of corporate groups can be, and has been, justified on the following tax policy objectives: fairness, neutrality, and economic growth/competitiveness. Simplicity has also been claimed as another policy objective of group taxation regimes. However, as discussed in Section 2.3.3.2 below, it is often sacrificed in the trade off between conflicting policy objectives. Before proceeding to the discussion of the justifications, the policy objectives are briefly explained in the following section.

2.3.3.1 Criteria to judge a tax regime
This section provides an overview of the tax policy objectives to facilitate subsequent discussion and evaluation of the application of the enterprise doctrine in group taxation regimes.

The generally accepted tax policy objectives of a good income tax system are simplicity, fairness, neutrality and competitiveness. These principles are discussed in the following paragraphs and wherever appropriate are used to evaluate the alternative policy options adopted in the consolidation regimes in the eight selected countries.

Simplicity is "a word that ... points to a complex of ideas".\textsuperscript{25} It incorporates the concepts of the compliance costs of taxpayers and the administrative costs of tax authorities. These two concepts are connected and "add up to much the same as the ancient canon of certainty".\textsuperscript{26} It has been suggested that in a trade off between conflicting tax policy objectives, simplicity is "almost always


\textsuperscript{26} Asprey Report, ibid, paragraph 3.20.
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This is perhaps true in many cases. Nevertheless, simplicity remains as an important objective for a tax system.

Fairness is also a concept that is "exceedingly difficult to define and harder to measure". Nevertheless, as "a quality of a ... tax system everyone demands fairness". It is customary to distinguish two dimensions of fairness reflecting the ability to pay principle. Horizontal equity refers to the notion that two persons should pay the same amount of tax if they have the same ability to pay. Vertical equity, on the other hand, demands that a person with more ability to pay should pay more tax.

The neutrality principle dictates that ideally a tax system should not interfere with a taxpayer’s decisions on allocation of resources. For instance, a tax system should not affect a businessman’s choice between different forms of business structure. The policy objective of neutrality represents the economic concept of efficiency which should guide the allocation of resources in a society to minimise wastage.

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29 Asprey Report, above note 25, paragraph 3.7.

30 Ibid.

31 It is difficult to have a consensus on the definition of a person’s ability to pay, and how to measure it. For a detailed discussion of the fairness principle and the issues of measuring the ability to pay, see for example Harris, above note 19, at 11-31.

32 Asprey Report, above note 25, paragraph 3.23.
Competitiveness or economic growth is a more proactive concept than neutrality. While the latter requires minimum interference with business decision, the former suggests that a tax system should promote economic growth and improve the competitiveness of businesses in a country.\textsuperscript{33}

The four tax policy objectives of simplicity, fairness, neutrality and competitiveness have a long history. Adam Smith’s “four maxims with regard to taxes” incorporated either directly or indirectly all four policy objectives.\textsuperscript{34} They are cited regularly as the policy objectives for tax systems around the world, though their relative importance may change over time. For instance, in Australia, the 1975 Taxation Review Committee believed that the “big three” criteria to judge a tax regime are fairness, simplicity and efficiency (or neutrality).\textsuperscript{35} “Economic growth” (or competitiveness) was considered less important: it was recognised as “another objective that, in view of some, should be deliberately and distinctly pursued in taxation policy”.\textsuperscript{36}

In terms of the relative importance of the policy objectives, the tide has turned for competitiveness in recent years. In 1999, the Review of Business Taxation reckoned that “three major [national taxation] objectives guide the development of the business taxation system”: economic growth (which, to the Review, incorporated the neutrality principle), fairness and simplification.\textsuperscript{37} The Review further indicated that the three national taxation objectives are “interdependent and must be pursued jointly ... Any decision to trade off one

\textsuperscript{35} Asprey Report, above note 25, paragraphs 3.6 – 3.26.
\textsuperscript{36} Ibid, paragraph 3.28.
\textsuperscript{37} Ralph Report, above note 33, at 104-107.
objective against another should be taken explicitly ...”.\textsuperscript{38} In any case, the fact that the competitiveness objective is among the “big three” this time and is mentioned first in the list suggests that it is at least as important as, and may be more dominant than, the other objectives.\textsuperscript{39}

In practice, besides the above generally accepted tax policy objectives, governments often have to take into consideration other tax policy objectives in designing their tax systems. For instance, the tax revenue impact of a tax policy option may prove to be unacceptable to the government. Another important tax policy objective is anti-avoidance: “A tax rule that can be readily avoided is not a good rule”.\textsuperscript{40} The policy option adopted in a country is often the result of difficult compromises between conflicting policy objectives. This is apparent in the findings of the comparative study in Part Two of this thesis.

2.3.3.2 Justifications to apply the enterprise doctrine to group taxation regimes

(1) Simplicity

Simplicity has been claimed to be one of the reasons to deviate from the traditional separate entity doctrine and tax a corporate group as one single entity. For instance, Australia explicitly stipulates in its tax law that one of the objectives of the consolidation regime is to “reduce the cost of complying with

\textsuperscript{38} Ibid, at I04-105. Other countries often adopt similar “joint consideration and trade off” approach: e.g. in the U.K.: HM Treasury and HM Revenue & Customs, above note 28, paragraph 2.5; and the U.S.: President’s Advisory Panel on Federal Tax Reform, above note 27, at xiii.

\textsuperscript{39} In Australia’s most recent tax reform review – Australia’s future tax system (commonly known as the Henry Review) – fairness, efficiency and simplicity are among the goals of a tax system while competitiveness is also recognised as a key determinant, especially for business taxes. For a discussion of the policy objectives, see The Treasury, Australia’s Future Tax System - Consultation Paper (2008, Treasury, Canberra), Chapter 1; and Ken Henry et al, Australia’s future tax system - Report to the Treasurer - Part One - Overview (2009, Treasury, Canberra), Chapter 2.

[the tax law]; and ... improve business efficiency by removing complexities and promoting simplicity in the taxation of wholly-owned groups”.

Simplicity has also been put forward as one of the rationales for introducing a single common consolidated corporate tax base for the entire European Union.

However, the perceived simplicity of the application of enterprise doctrine to corporate groups can be deceptive. Experiences of implementing group taxation regimes suggest that they are inevitably complex. The stronger the application of the doctrine in a group taxation regime is, the more complex the system tends to be. This is because a group taxation regime – which applies the enterprise doctrine – has to interact and mesh with the rest of the tax system which is premised on the separate entity doctrine. The inherent conflict and tension between the two doctrines inevitably creates complexity.

Another common claim about the perceived simplicity of applying the enterprise doctrine to corporate groups is the possible removal of some anti-avoidance provisions for corporate groups. For instance, if a group is treated as one taxable unit and intra-group transactions are ignored for income tax purposes, specific anti-avoidance provisions for transfer pricing and value shifting become redundant and are no longer required. However, the perceived simplification is often a myth. In most cases group taxation regimes in practice apply to a subset of the worldwide group (for example, only to resident group companies in a country). The anti-avoidance provisions are indispensable to deal with cross-border intra-group transactions.

41 S.700-10(c) ITAA1997.


43 The complexity and issues arising from applying the enterprise doctrine in the context of a consolidation regime are analysed in detail in Part 2 of this thesis.
The pursuit of simplicity in the context of group taxation is difficult. The Ralph Report in Australia summarised the issue of pursuing simplicity in a business tax system as follows:44

Because of the inherent complexity in many business transactions, the business tax system will always contain complex provisions. The objective of simplification should be applied in two ways:

- The business tax system should be designed in as simple a manner as possible recognising economic substance in preference to legal form.

- Where the tax treatment of particular transactions is likely to be complex, such additional complexity in the tax law should be justified by the improvement in equity or economic growth that may be achieved.

In summary, simplicity may be, and has been, claimed as one of the policy objectives of introducing a group taxation regime. However, the introduction of the regime is often justified on other policy objectives such as competitiveness and neutrality. Simplicity is often sacrificed in the trade off between policy objectives.45

(2) Fairness
 Traditionally, the fairness principle in tax law used to be applied to individuals

44 Ralph Report, above note 33, at 106.
45 After studying the experience of tax reviews in Australia from 1920 to 1999, Evans and Krever concluded that a “notable and undesirable outcome of tax reforms and tax changes has been the exponential growth in complexity of the tax system”; Chris Evans and Richard E Krever, “Tax reviews in Australia: before and after Henry” (2009) 4 British Tax Review 339, at 349.
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and not directly to companies, as the Asprey Report in 1975 suggested:46

Equity is essentially a matter of comparative justice between individuals. Any tax on corporations may (or may not) be fair to its owners, its employees or to the purchasers of its products; but it cannot be said either to be fair or unfair to the corporation as such.

The application of the fairness objective to companies is basically to treat companies as the intermediary of its ultimate individual shareholders.47 The fairness of a corporate tax system is judged, from the perspective of the individual shareholders, by comparing two amounts received by an individual shareholder: (a) the net-of-tax amount after income is passed through a company with taxes paid (if any) at the company and individual levels; and (b) the net-of-tax amount if the individual receives the income directly without passing through a company.48

Nevertheless, many countries appear to have applied the fairness principle directly to companies. For instance, in the U.K., fairness is one of the objectives of the corporate taxation system, in particular, the “focus on fairness includes ensuring that companies receiving the same economic returns bear the same amount of tax …”49 Australia has a similar position and recognises that the fairness principle in the business tax system “relates principally to

46 Asprey Report, above note 25, paragraph 3.33.
47 This is evident in the 1966 Canadian Report on Taxation, which stated that the “failure of the present Canadian tax system to permit offsetting of profits and losses with a group of companies operated under common control does not arrive at a proper measure of the shareholders’ ability to pay …” (emphasis added): Royal Commission on Taxation (Canada), Report of the Royal Commission on Taxation - Volume 4 Taxation of Income (1966), at 260.
48 Asprey Report, above note 25, paragraph 3.33.
49 HM Treasury and HM Revenue & Customs, above note 28, paragraph 1.3.
horizontal equity".\textsuperscript{50} It may be argued that the above statements in fact refer to the neutrality principle, which is discussed below.

Another aspect of fairness deals with cross-border transactions. Inter-nation equity means that tax revenue on international transactions should be shared between countries on an equitable basis.\textsuperscript{51} It is difficult to refute this general assertion for a "fair share" for all countries concerned. However, it is extremely difficult to define a commonly acceptable definition of "equity" in this context.\textsuperscript{52}

In general, there are two dimensions of inter-nation equity:

1. a fair allocation of taxing rights between countries; and
2. a fair allocation of income between countries.

In the inter-jurisdiction context, it is more difficult to apply the fairness principle, as there is no consensus of what "fairness" means. As Musgrave observed, "Which rule is followed, as in most other equity issues, has to be a matter of judgement by national consensus" (emphasis added).\textsuperscript{53} This issue is evident in the CCCTB project in the EU, in which countries argued heatedly

\textsuperscript{50} Ralph Report, above note 33, at 105. There is also support from academics to apply the fairness principle to companies: for example, Peggy B Musgrave, "Combining Fiscal Sovereignty and Coordination: National Taxation in a Globalizing World" in Inge Kaul and Pedro Conceição (ed), The New Public Finance: Responding to Global Challenges (2006) 167, at 170; and Michael J Graetz, "The David R. Tillinghast lecture: Taxing International income: inadequate principles, outdated concepts, and unsatisfactory policies" (2001) 54(Spring) Tax Law Review 261, at 303.

\textsuperscript{51} For a brief discussion of this criteria, see for example Arnold, note 40 above, at 16.

\textsuperscript{52} For a brief discussion of this issue, see for example Jinyan Li, "Global Profit Split: An Evolutionary Approach to International Income Allocation" (2002) 50(3) Canadian Tax Journal 823.

over which tax revenue sharing formula was “fair”.

(3) Neutrality
A tax system should be neutral in the sense that ideally it should not affect the business decisions of a taxpayer. It follows that a tax system should not influence the decision to choose the most appropriate legal structure of a business. The choice between a branch and a subsidiary ideally should have the same tax outcome.

Under the enterprise doctrine, a corporate group – despite comprising separate legal entities – is treated as one single taxable unit as the group is under the common control of the parent company. The tax outcome is similar to a company operating with branches. The two alternative corporate structures are “functionally equivalent”. The application of the doctrine to corporate groups in which subsidiaries are under the common control of a parent company is therefore consistent with the neutrality principle. A company operating through a branch should be taxed similarly to another company that generates the same amount of taxable income through a subsidiary under its control. The legal form of the group structure should be irrelevant.

(4) Competitiveness
Competitiveness refers to the policy objective of a tax system to enhance the competitiveness of a country’s businesses and to promote economic growth.

Competitiveness has been an increasingly important driver of tax policies in

54 The issue is discussed in more detail in Chapter 11 Section 11.5.1.
56 For an interesting discussion of the policy objective of competitiveness with respect to the international taxation rules in Canada, see Arnold, above note 40, at 199-201. In particular, Arnold argued that the policy objective of competitiveness may justify an exemption regime for foreign business income in Canada, but cannot justify the policy of allowing deduction of interest incurred to earn the exempt foreign-source income.
practice. Many countries have introduced tax regimes to attract foreign investments, or to promote the competitiveness of domestic businesses.  

Applying the enterprise doctrine to a group taxation regime can achieve the competitiveness objective. It has been argued that “it may be possible to enhance competitiveness by improving efficiency of the tax system with respect to its treatment of corporate groups”. The policy objective of competitiveness can also be achieved on a pragmatic level. For example, a consolidation regime allows intra-group loss offset. The overall tax liability of a group is thus lowered, making the group more competitive. Many countries have introduced a consolidation regime in pursuit of the policy objective of competitiveness. For instance, Spain introduced its consolidation regime “to improve competitiveness and promote economic growth”. Similarly, Japan’s consolidation regime was designed to “enable … Japanese corporations [to be] more competitive …”.

In summary, the application of the enterprise doctrine to the taxation of corporate groups can be justified primarily on the two policy grounds: neutrality and competitiveness. Though simplicity is sometimes claimed to be one of the policy objectives for introducing a group taxation regime, it is difficult to achieve in practice. A group taxation regime in most cases is introduced as a compromise between conflicting policy objectives, with

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58 Department of Finance (Canada), above note 55, at 2.


simplicity often sacrificed for the other policy objectives.

### 2.4 Theoretical models of application of the enterprise doctrine

This section explores the possible forms of application of the enterprise doctrine to the taxation of corporate groups from a theoretical perspective. It aims to develop a framework to facilitate the review and classification of the actual group taxation regimes in the next chapter.

A country often develops its group taxation regimes from the traditional position of treating a company as a separate taxable unit. The enterprise doctrine may override the separate entity doctrine and be applied to a corporate group in a number of dimensions. The varying degrees of application of the doctrine in the different dimensions produce a spectrum of group taxation regimes. The two key dimensions under which the enterprise doctrine may be applied to the taxation of corporate groups are:\(^61\)

1. taxable unit; and
2. tax base.

The following section discusses these two key dimensions. It paves the way for the development of a taxonomy of group taxation regimes in Section 2.4.2.

### 2.4.1 Key dimensions of application of the enterprise doctrine

#### 2.4.1.1 Dimension of taxable unit

\(^61\) Other dimensions of the application of the enterprise doctrine to the taxation of corporate groups include optionality (i.e. whether a group taxation regime is mandatory or elective; and whether such an election is irrevocable, for a fixed term, or can be revoked at any time) and the “all in” rule (i.e. whether all eligible group companies must join a group taxation regime, or the group can “cherry-pick” companies for the regime). The dimensions are discussed in detail in the comparative study of the eight consolidation regimes in Chapters 4 to 8.
"Taxable unit" is a key dimension of the application of the enterprise doctrine. Under the separate entity doctrine, a company is a stand-alone taxable unit. In contrast, under the enterprise doctrine, a country may extend the definition of the taxable unit to be a group of companies under the common control of a parent company. The taxable unit may be defined to comprise all group companies resident in the country ("country group"). Alternatively, a country may adopt a stronger application of the enterprise doctrine and define the taxable unit to be all group companies – including both resident and non-resident subsidiaries – under the common control of a parent company that is a resident of the country ("worldwide group"). In theory, a country may also define the taxable unit to be the group companies resident in a number of participating countries ("bloc group"). However, the possibility of a country unilaterally defining the taxable unit to be a bloc group may be remote. This is because, if the country is bold enough to define the taxable unit on a cross-border basis, the definition is likely to cover the worldwide group. There is no good reason in practice to limit the definition to a bloc in this case. It is more likely for a bloc (for example, the EU) to define, on a multilateral basis, the taxable unit to be a bloc group.

The possible definitions of the taxable unit for corporate groups under the enterprise doctrine are depicted in Diagram 1 below, in which it is assumed that the world has three countries A, B and C and the application of the enterprise doctrine is from the perspective of country A:

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62 The definition may be expanded to include permanent establishments of non-resident companies in the country: see discussion of "eligible entities" for the consolidation regimes of the eight countries in Chapter 5 Section 5.2.

63 The CCCTB project is the example. The key issue of this multilateral model is the mechanism to share the bloc group’s tax base among the participating countries in the bloc. See Chapter 11 for detailed discussion of the proposed model and its problems.
If a country applies the enterprise doctrine and defines the taxable unit to be a group of companies, the next policy issue is the definition of its tax base. This is the other key dimension of the application of the doctrine and is discussed in the following paragraphs.

### 2.4.1.2 Dimension of tax base

Under the separate entity doctrine, a company resident in a country is defined to be the taxable unit and its tax base is defined to be its taxable income or loss
determined according to the tax rules of the country. In contrast, under the enterprise doctrine, the tax base of a taxable unit can take into account the taxable income and losses of its group members. The possible definitions of the tax base depend on how the taxable unit is defined.

Before addressing this issue, however, it is necessary to explain how international tax norms affect the tax base dimension in particular.

(1) Relationship to international tax norms
The design of the structural elements of the corporate tax system, including the extent of application of the enterprise doctrine nowadays will inevitably take account of the international norms for taxing corporate income. These norms are partly created by or at least reflected in tax treaties based on international models, and partly produced by adoption of similar domestic laws often through policy coordination at the international level. They are the outcome of international coordination of tax policy over many decades. It is not intended here to discuss the policy basis for the norms but rather to outline the constraints which they can impose on the application of the enterprise doctrine across borders. The most serious constraint relates to the tax base dimension and hence the issue is introduced at this point. The discussion here also explains why the international norms have less impact on the most common way of applying the enterprise doctrine across borders, that is, limiting it to residents of a country (and in some cases, permanent establishments of non-residents in the country).

Nominally the international norms tax residents on their worldwide income and non-residents on their income sourced in the jurisdiction concerned (which may be national, sub-national or supranational). The international system in

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general adopts the so-called separate-enterprise arm's-length principle for taxing international business income. The system is based on treating a resident company of one country (or a group of resident companies of one country) as a separate enterprise from the resident companies of other countries, that is, effectively the application of the separate entity doctrine across international borders.

International allocation of business income among countries is then effected by the arm's length principle under which a resident company (or group of resident companies) of one country is treated as transacting with related companies resident in other countries in the same way as unrelated companies. Any attempt to apply the enterprise doctrine across borders in the tax base dimension thus contradicts one of the building blocks of the current international tax system which is embedded in some 3,000 bilateral tax treaties among countries. Hence in practice the application of the enterprise doctrine across borders in the tax base dimension is only likely to occur at the sub-national level or (possibly) at the supra-national bloc level where the bloc has some similarities to a federation such as the European Union.

Despite the appearance of taxation of worldwide income of residents, the international tax system for companies' business income (as opposed to passive income) increasingly operates on a source only basis due to the proliferation of participation exemptions for dividends, capital gains and foreign branches of resident companies under tax treaties and domestic tax

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66 An example of the failed attempt to apply the enterprise doctrine in the definition of the tax base on a cross border basis is the worldwide FA regime in California: see discussion of the regime in Chapter 3 Section 3.4.
laws.\textsuperscript{67} Hence an application of the enterprise doctrine by a country only to companies resident in that country in effect operates on a source only basis for the calculation of business income and does not create international conflicts with other countries' tax systems nor contradict international norms reflected in tax treaties. The same remains true if the country extends its application of the enterprise doctrine to permanent establishments of non-residents in that country.

For asset transfers within a group of companies, most countries limit tax relief to resident companies, and assets like land in the country and movable property of a permanent establishment in the country, which is designed to prevent assets effectively being removed from the tax residence and source jurisdiction of the country.\textsuperscript{68} Again this result effectively reflects a source basis of taxation in applying the enterprise doctrine to groups of companies, despite the nominal application to resident companies.

In relation to non-business income of companies, that is, passive income not derived as part of the normal business of a company, most countries do tax resident companies on foreign source income they derive (such as interest). This kind of taxation does not, however, generally produce any international conflicts whether applied by a country on a single entity basis or on a group basis under the enterprise doctrine, partly because the income is usually subject to only limited tax at source and subject to a foreign tax credit in the residence country.\textsuperscript{69}

\textsuperscript{67} See for example Ault and Arnold, above note 64, at 446-452.

\textsuperscript{68} Yoshihiro Masui, “General Report” in International Fiscal Association, Cahiers de Droit Fiscal International Volume 89b: Group Taxation (2004), Section 2.5.

\textsuperscript{69} For a comparison of the withholding tax rules on passive income in a number of countries, see Ault and Arnold, above note 64, at 510-515.
Indeed in this area countries commonly extend the enterprise doctrine across borders and seek to tax foreign source passive income of foreign companies within a corporate group where the controlling company is located in the country. This form of taxation, however, is typically effected by a separate application of the enterprise doctrine generally referred to as controlled foreign company regimes. Such regimes in general are designed to be limited in impact to passive and base company income. Until recently such regimes were spreading rapidly around the world. Now the regimes are in retreat in the sense that they are being considerably reduced in scope so as only to catch clearly abusive cases. In part this retreat extends from doubts about their compatibility with international tax norms reflected in tax treaties (and in particular their interactions with European Union law), but more importantly reflects a reassessment of the international tax policy underpinnings of the regimes. Such regimes are not considered further in this thesis, but their existence both demonstrates another application of the enterprise doctrine and explains why it is possible to limit other applications of the enterprise doctrine effectively to income sourced in a country operating through a combination of limitation to resident companies (and permanent establishments of non-residents) and effective exemption of foreign source business income from tax under participation exemption regimes.

(2) Possible definition of tax base under the enterprise doctrine

With the understanding of the constraints imposed by the international tax norms discussed above, the following paragraphs explore how the enterprise...

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71 For example, for a good summary of the development of the CFC regime (and its reducing scope) in Australia, see Ault and Arnold, above note 64, at 482-484.
doctrine can be applied in the dimension of tax base.

(i) A country group as the taxable unit:
If the taxable unit is defined to be a country group, its tax base may be defined to be the sum of the taxable income and losses of the group members. The taxable income and losses are calculated according to the tax law of the country. An important implication of this definition is that it effectively allows intra-group loss offset, which is often the key function of a group taxation regime.

The enterprise doctrine may be applied further in the definition of a country group’s tax base by eliminating intra-group transactions in the computation of its tax base. This policy effectively allows tax free intra-group asset transfer, which is another key function of a group taxation regime. In fact, intra-group loss offset and tax free intra-group asset transfer are the two key functions that a group taxation regime is typically designed to achieve.

Instead of defining the tax base of a country group to be the sum of the taxable income and losses of its group members, a country may define the tax base to be a portion of the taxable income or loss of the bloc group or worldwide group to which the country group belongs. In computing the group’s taxable income or loss, intra-group transactions may be eliminated.

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72 Examples include group pooling regimes in Luxembourg and Mexico. See Chapter 3 Section 3.3 for more detail.
73 Examples include consolidation regimes in Australia and the U.S. See Chapter 3 Section 3.3 for more detail.
74 Masui, above note 68, at 31.
75 Such a model had been suggested for the countries under the North American Free Trade Agreement: for details of the proposal, see McDaniel, above note 23.
76 The policy of eliminating intra-group transactions in the computation of a group’s taxable income or loss complies with the enterprise doctrine, as the group is treated as one enterprise
There are a variety of methods to determine the portion of the taxable income of the bloc or worldwide group that may be defined to be the tax base of a country group.\textsuperscript{77} For instance, a simple method is to allocate the group's tax base according to the group's overall profit margin on the costs incurred in the country.\textsuperscript{78} Some have suggested value added in each country.\textsuperscript{79} The main problem with this method is that the amount of value added in a jurisdiction may be difficult to calculate or not readily available.\textsuperscript{80} Others have discussed the possibility of using industry or macro-based factors such as the size of a country's economy.\textsuperscript{81}

Nevertheless, the formulary appointment ("FA") method has occupied the centre stage in the debates on the allocation of profits of multinational
corporate groups for many decades. Under the FA method, a group’s tax base is allocated to a country according to a pre-determined formula. The formula is typically based on the weighted average of geographically-specific apportionment factors, such as payroll, assets and sales. The FA method may be applied either unilaterally by a country, or multilaterally among a group of countries. The arguments for the FA method, and its problems which were highlighted by the experience of the CCCTB project, are discussed in detail in Chapter 11 “A Reality Check for Multilateral Consolidation: the CCCTB Experience”.

There is extensive literature on the FA method. For instance, the formulary apportionment method was discussed as one of the methods to allocate income of a cross-border enterprise to its local establishment in the early 1930s: see Mitchell B Carroll, Taxation of Foreign and National Enterprises: Volume 4: Methods of Allocating Taxable Income (1933, League of Nations, Geneva), paragraph 122. After an extensive survey of the prevailing practice in different countries, Carroll rejected formulary appointment (referred to as “fractional apportionment” in the report) as the primary method to allocate income of a multinational group mainly for the following reasons: (1) the method was inconsistent with the traditional and widely accepted residence principle of taxation; (2) administrative difficulties (e.g. obtaining and verifying overseas data, different accounting methods, language, etc.) and compliance costs (e.g. preparing financial statements for all group entities according to a particular country’s tax law) were significant; and (3) political resistance was substantial as most countries were not willing to surrender taxing rights over profits arising in their countries: ibid, paragraphs 666-670. The method was also discussed briefly in a UN report more than 30 years ago, but was quickly dismissed for “reasons of practicability and equity”: United Nations, The Impact of Multinational Corporations on Development and on International Relations (1974, UN, New York), at 93. In particular, the report stated that “even in a federal union, such as the United States, no agreement [on a formula] could be reached between the states. The task of bringing about an agreement ... at an international level would be even more formidable ... Moreover, what would be allocated between countries would be the income, not the tax; thus competitive tax concessions between host countries could proliferate to a point which would be contrary to an equitable sharing of the tax burden between the corporations and the average citizens in a developing country”. For examples of more recent proposals of the method, see for example Li, above note 52; and Reuven S Avi-Yonah and Kimberly A Clausing, “Business Profits (Article 7 OECD Model Convention)” in Michael Lang et al (eds), Source versus Residence, EUCOTAX Series on European Taxation (2008, Kluwer, Alphen aan den Rijn). For a proposal to use the FA method to allocate the residual profit in the profit split method under the OECD Transfer Pricing Guidelines, see Reuven S Avi-Yonah, “Between Formulary Apportionment and the OECD Guidelines: A Proposal for Reconciliation” (2010) 2(1) World Tax Journal 3. For books on the FA method, see for example Joann Martens-Weiner, Company Tax Reform in the European Union: Guidance from the United States and Canada on Implementing Formulary Apportionment in the EU (2006, Springer, New York); Ioanna Mitroyanni, Integration Approaches to Group Taxation in the European Internal Market, EUCOTAX Series on European Taxation (2008, Kluwer, Alphen aan den Rijn); and Stefan Mayer, Formulary Apportionment for the Internal Market, IBFD Doctoral Series (2009, IBFD, Amsterdam).
(ii) A bloc group or worldwide group as the taxable unit:

If a worldwide group is defined to be a taxable unit in a country, its tax base may be defined to be the sum of the taxable income and losses of its group members computed according to the tax law of the country. This definition again effectively allows intra-group loss offset, a key function of a group taxation regime.

As discussed in Section 2.4.1.1 above, it is unlikely for a country to unilaterally define the taxable unit to be a bloc group. This model is therefore not discussed in detail. However, countries in a bloc may agree to a common definition of the taxable unit to be a bloc group. In that case, the tax base of the bloc group may be defined to be either the sum of the taxable income and losses of its group members, determined according to a common set of tax rules. Alternatively, it may be defined to be a portion of the taxable income or loss of the worldwide group to which it belongs. Each participating country in the bloc may then share a portion of the tax base by the FA method.

The discussion of the definition of tax base so far focuses on a taxable unit being defined to be a group of companies. However, even if a country follows the separate entity doctrine and defines a company to be the taxable unit, the enterprise doctrine can still be applied in the definition of its tax base.

For a company that is defined to be the taxable unit, its tax base may be defined to be its taxable income or loss plus certain tax attributes of other group members. The incorporation of tax attributes of other group members in

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83 Examples include the worldwide group pooling regimes in France and Italy. See Chapter 3 Section 3.3 for more detail.

84 In theory, it is possible to extend the application of the enterprise doctrine in the definition of the tax base of a worldwide group by eliminating intra-group transactions in the computation of the group's taxable income or loss. However, to the knowledge of the author, no such regime exists in practice.
the definition of the tax base of a company represents an application of the enterprise doctrine. For example, the tax base of a company may be defined to include taxable income or losses of a group member.\textsuperscript{85} This definition of the tax base effectively allows intra-group loss offset. It is also possible to define the tax base of a company by deferring the recognition of any gain or loss of intra-group asset transfers.\textsuperscript{86}

The possible definitions of the tax base of a company by incorporating certain tax attributes of other group members are depicted in Diagram 2 below:

\textbf{Diagram 2 Possible definitions of tax base of a company with tax attribute transfer}

\begin{center}
\includegraphics[width=\textwidth]{diagram2.png}
\end{center}

The tax base of a company may be defined under the enterprise doctrine in an

\textsuperscript{85} Examples include the group contribution regime in Finland and the group loss relief regime in the UK. The definition of the tax base may even include tax attributes of non-resident group members in a bloc like the EU. See Chapter 3 Section 3.4 for more detail. A similar but separate application of the enterprise doctrine is the CFC regime under which certain income of a non-resident company is attributed to a resident company. As discussed above with respect to the international tax norms, this regime is not considered further in this thesis.

\textsuperscript{86} Examples include the tax free intra-group asset transfer regimes in India and the UK. See Chapter 3 Section 3.4 for more detail.
alternative way: as a portion of the taxable income or loss of the corporate group – for example, the country group, bloc group or worldwide group – to which the company belongs. The tax base of the corresponding group would be determined according to the tax rules of the country, with intra-group transactions eliminated. The portion of the group’s tax base that is defined to be the tax base of the resident company may be determined by the FA method.\(^87\) The cross border models are much less likely in practice due to the constraints imposed by the international tax norms discussed above. The possible definitions of the tax base of a company in the form of tax base apportionment are depicted in Diagram 3 below:

Diagram 3 Possible definitions of tax base of a company with tax base apportionment

\(^{87}\) The water’s edge FA regime in California in the United States is an example of such model. See Chapter 3 Section 3.4 for more detail.
2.4.2 Taxonomy of group taxation models under the enterprise doctrine

Traditionally, each company in a corporate group is treated as a separate taxable unit under the separate entity doctrine. Taxable income or loss of the company is in general taken as the tax base of the company. As discussed in the preceding section, starting from this base position, the enterprise doctrine may be applied to override the separate entity doctrine in two key dimensions: taxable unit and tax base. The two key functions that a group taxation regime is typically designed to achieve are intra-group loss offset and tax free intra-group asset transfer. 88

The possible applications of the enterprise doctrine in the two key dimensions are depicted in Diagram 4 below:

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88 In this context, "intra-group asset transfer" refers to the tax attribute of a group taxation regime that allows tax free transfer of assets within a corporate group without the need of a corporate restructure.
Diagram 4: Key dimensions of application of the enterprise doctrine to the taxation of corporate groups

Enterprise doctrine

Key dimension: taxable unit

- Country group
- Bloc group
- Worldwide group

Key dimension: tax base

Alternative

- Sum of taxable income and losses of group members
- Portion of bloc/worldwide group's taxable income or loss
- Sum of taxable income and losses of group members
- Portion of worldwide group's taxable income or loss
- Sum of group members' taxable income and losses
- Company's taxable income and losses, adjusted for selected group member's taxable income or loss, or intra-group asset transfer

Possible additional function

- Tax free intra-group asset transfer
- Tax free intra-group asset transfer
- Tax free intra-group asset transfer

Direct application of the doctrine to a company as the taxable unit
Chapter 2 Enterprise Doctrine – Theory

This taxonomy of group taxation models – developed in terms of the two key dimensions of the application of the enterprise doctrine – provides the framework for the review and classification of the actual group taxation regimes in the next chapter.

2.5 Conclusion

This chapter has argued that the rise of corporate groups in the last century poses a serious challenge to the traditional separate entity doctrine under which a company is treated as a separate taxable unit. The enterprise doctrine – which focuses on the economic substance of a group instead of its legal form – is more appropriate for the taxation of a corporate group. Treating a group as a taxable unit is consistent with the neutrality principle. The application of the enterprise doctrine to corporate groups also improves the competitiveness of businesses. The sacrifice of the simplicity objective can be, and is often, justified on these policy grounds.

In theory, the enterprise doctrine may be applied to the taxation of corporate groups in two key dimensions: taxable unit and tax base. The taxable unit may be defined to be a country group, a bloc group or a worldwide group. For a corporate group which is defined as the taxable unit, its tax base may be defined to be the sum of the taxable income and losses of its group members or a portion of the taxable income or loss of the larger group to which it belongs. The two key functions that a group taxation regime is often designed to achieve are intra-group loss offset and tax free intra-group asset transfers. The spectrum of group taxation regimes in the world represents different extents of the application of the enterprise doctrine with respect to the two key dimensions and the two key functions. The divergent degrees of the application of the doctrine in practice are testimony to the difficult
compromises that tax policy makers have to make in the design of a group taxation regime. The next chapter employs the taxonomy developed in this chapter to review and classify group taxation regimes in practice.
CHAPTER 3
APPLICATION OF THE ENTERPRISE DOCTRINE
TO THE TAXATION OF CORPORATE GROUPS
- PRACTICE

3.1 Introduction
This chapter reviews how the enterprise doctrine has been applied in practice in group taxation regimes. It builds on the discussion of the theoretical framework of applying the doctrine in Chapter 2, and aims to ascertain the different extents to which the doctrine has been applied in practice, given the constraints imposed on its application in the real world. Major constraints include the "differential span of political jurisdictions and economic enterprises"¹, the traditional separate entity doctrine which is embedded in the income tax law, and competing policy objectives such as simplicity, competitiveness and anti-avoidance.

Group taxation regimes in different countries often differ substantially, thus presenting a challenge when constructing a systematic analysis. It has been observed that it is "difficult to establish an exact 'family tree' of the group taxation regimes around the world. Lines are hard to draw. Exceptions

abound". Nevertheless, the purpose of this review is to employ the taxonomy developed in Chapter 2 and classify group taxation regimes in terms of the extent of the application of the enterprise doctrine.

This chapter first reiterates how the enterprise doctrine can be applied in the two key dimensions, namely taxable unit and tax base, and to achieve the two key functions of a group taxation regime, namely intra-group loss offset and tax free intra-group asset transfer. It then classifies group taxation regimes according to the extent of the application of the doctrine in the two key dimensions and also in respect of the two key functions.

The review in this chapter is not intended to be exhaustive and does not cover all group taxation regimes in every country. Instead, typical regimes in different countries are considered from the perspective of the enterprise doctrine with the objective of developing a systematic framework to classify the regimes. The review is based primarily on the 2004 IFA Report on group taxation, supplemented and updated by information available from various sources, including in particular the IBFD databases. Another IFA report also provides some valuable information: the 1998 Report on the tax treatment of corporate losses included some detailed discussion of treatment of losses in a group.

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4 The databases include “Europe – Corporate Taxation – Country Analysis”, “Asia Pacific – Taxation and Investment – Country Analysis” and “Canada – Taxation and Investment” (available at www.ibfd.org), accessed on various dates up to 28 December 2010.
3.2 Key dimensions of application of the enterprise doctrine

This section reiterates briefly the two key dimensions in which the enterprise doctrine can be applied in the taxation of corporate groups, facilitating the classification of actual group taxation regimes in Sections 3.3 to 3.5.

(1) Taxable unit

The application of the enterprise doctrine can extend the definition of a taxable unit from a single company to a corporate group of resident companies in a country (for example, the consolidation regimes in Australia and New Zealand). It is possible to apply the enterprise doctrine on a cross-border basis. Some countries expand the definition of taxable unit to include non-resident group companies (for example, the joint taxation regime in Denmark). A more ambitious attempt is a multilateral model in which not only the taxable unit is defined to include resident companies in the participating countries, but also one single group tax base is computed and shared among the countries (for example, the CCCTB project in the EU).

The application of the enterprise doctrine to expand the definition of the taxable unit to be a group of companies always implies a corresponding expansion of the tax base. For example, by defining the taxable unit to be a group of resident companies under a consolidation regime, the tax base is always expanded to include taxable income and losses of all the group members. However, this correlation does not always exist in reverse. An expansion of the tax base of a company can occur without expanding the taxable unit. For example, a company can remain as a separate taxable unit while its tax base is defined by taking into account the taxable income and losses of its group companies (for example, the group loss relief regime in the UK).
(2) Tax base

If a corporate group – for example, a country group, bloc group or a worldwide group – is defined to be the taxable unit in a country, its tax base may be defined to be the sum of the taxable income and losses of its group members, thus achieving intra-group loss offset. If intra-group transactions are eliminated in the computation of the group’s taxable income and loss, the definition of the tax base also achieves tax free intra-group asset transfer. For a country group, its tax base may alternatively be defined to be a portion of the taxable income or loss of the bloc group or worldwide group to which it belongs.

It is possible to define the tax base of a company under the enterprise doctrine without expanding the definition of taxable unit to a group basis. The tax base of a company – which remains as a separate taxable unit – may be defined by taking into account the taxable income or loss of other group members (for example, the group relief regime in the UK and the group contribution regime in Finland). Alternatively, the tax base may be defined to be a portion of the taxable income or loss of the group to which it belongs (for example, California’s water’s edge FA regime).

The following three sections review and classify different group taxation regimes according to the extent to which the enterprise doctrine has been applied in respect of the two key dimensions and also the two key functions of a group taxation regime.

3.3 Application of the enterprise doctrine: corporate groups as taxable unit

Diagram 5 below depicts the different group taxation regimes applying the enterprise doctrine in practice in respect of the dimension of the taxable unit:
Diagram 5 Application of the enterprise doctrine: corporate groups as taxable unit

**Stronger application of the enterprise doctrine**

**Enterprise doctrine**

**Key dimension: taxable unit**

- Country group
- Bloc group
- Worldwide group

**Key dimension: tax base**

- Sum of group members’ taxable income and losses
- Sum of group members’ taxable income and losses, plus tax free intra-group asset transfer
- Sum of group members’ taxable income and losses

- **Group pooling** (Italy (since 2008), Luxembourg, Mexico, Poland & Portugal)
- **Consolidation** (Australia, France, Italy (before 2008), Japan, Netherlands, New Zealand, Spain, South Korea & U.S.)
- **CCCTB project** (EU)
- **Worldwide group pooling** (France & Italy), **joint taxation** (Denmark) & **Unternehmensgruppe** (Austria)

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Chapter 3 Enterprise Doctrine – Practice

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The regimes are sorted from left to right according to the extent of application of the enterprise doctrine in terms of the taxable unit dimension. Starting from the base position of treating a company as a separate taxable unit under the separate entity doctrine, the enterprise doctrine may be applied to define the taxable unit as a group of companies in the following regimes:

(1) Group pooling:
Countries with a group pooling regime include Italy,^6 Luxembourg, Mexico,^7 Poland and Portugal. Under this regime, a group of resident companies is defined to be a taxable unit, and computes its taxable income or loss by aggregating the individual results of each group member. Intra-group loss offset is thus achieved. The major difference between this regime and consolidation (as defined for the purpose of this thesis) is that it does not allow tax free intra-group asset transfer. The group pooling regime is therefore not as comprehensive as a consolidation regime.

(2) Consolidation:
Countries with this regime include Australia, France, Italy (before 2008),^8 Japan, the Netherlands, New Zealand, Spain and the U.S. South Korea has

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^6 Italy introduced a domestic consolidation regime in 2004 allowing both intra-group loss offset and tax free asset transfer. However, the policy of intra-group asset transfer was abolished in 2008: Fabrizio Bendotti, “Italy” in Guglielmo Maisto (ed), International and EC Tax Aspects of Groups of Companies, EC and International Tax Law Series (2008, IBFD, Amsterdam), at 338-339. The regime therefore becomes a group pooling regime. Nevertheless, its consolidation regime (from 2004 to 2007) is included in the comparative analysis in this thesis for a more comprehensive study.

^7 Since 1991, non-resident subsidiaries had the option of joining the group pooling: Aage Michelsen, “General Report” in International Fiscal Association, Cahiers de Droit Fiscal International Volume 83a: Tax treatment of corporate losses (1998), at 57-58. However, the possibility was not taken up by taxpayers in practice due to onerous requirements and was subsequently removed: Mario Calderón Danel, “Branch Report: Mexico” in ibid, at 645-646.

^8 See footnote 6 above.

^9 The consolidation regime in the U.S. allows in very limited circumstances certain companies incorporated in Canada and Mexico to be included in a consolidated group, one of the
introduced a consolidation regime in 2010. The regime treats a group of resident companies as a taxable unit. It is comprehensive as the group treatment applies to both intra-group loss offset and intra-group asset transfers.

(3) Consolidation of a bloc group - CCCTB:
The CCCTB project in the EU is the first serious attempt to apply the enterprise doctrine on a multilateral basis. In broad terms, a group of companies resident in the EU is treated as a taxable unit and can file a single return to report the consolidated taxable income or loss of the group. The group’s tax base would be shared among the member states under the FA method. However, the project appears to have been stalled and lost its momentum. It is unclear at the time of writing this thesis whether or not the project will proceed further.

(4) Worldwide group pooling:
The application of the enterprise doctrine can be pushed further in this dimension by defining the taxable unit to be a worldwide group of companies. In other words, the taxable unit is defined to include both

conditions being that the foreign corporation is taxed as a domestic corporation: Section 1504(d) IRC.


11 A similar model was proposed by Paul McDaniel in 1994 for the three countries under the North American Free Trade Agreement (“NAFTA”), namely Canada, Mexico and the U.S., but was not pursued by the governments. Under the proposal, each country would determine a corporate group’s tax base under its own income tax law. A portion of that tax base – determined under a commonly agreed apportionment formula between the three countries – would be subject to corporate tax in the corresponding country. For details of the proposal, see Paul R McDaniel, “Formulary Taxation in the North American Free Trade Zone” (1994) 49 Tax Law Review 691.

12 The FA method, in particular the CCCTB project, is discussed in more detail in Chapter 11 “A Reality Check for Multilateral Consolidation: The CCCTB Experience”.

13 Some countries, especially European countries, have expanded the scope of their group taxation regimes to domestic permanent establishments of non-resident companies. Examples include Austria, Australia (for banks), Finland, Germany, Italy, Luxembourg, the Netherlands, New Zealand, Norway, Spain, Sweden and the UK: Masui, above note 2, at 53-54. This type
resident and non-resident group members under the common control of a parent company. Several regimes fall into this category, including the worldwide group pooling regimes in France\textsuperscript{14} and Italy, the joint taxation regime in Denmark and Unternehmensgruppe in Austria.\textsuperscript{15} Under the regime, a resident parent company can elect to file a single group return with its subsidiaries, both residents and non-residents. It allows intra-group loss offset, but not tax free asset transfer. Therefore, the regime is not a comprehensive consolidation regime as defined for the purpose of this thesis.

### 3.4 Application of the enterprise doctrine: tax base of a company

As discussed in Section 3.2 above, it is possible to apply the enterprise doctrine in the definition of the tax base of a company without redefining the taxable unit. While keeping a company as the taxable unit, the doctrine may be applied in the dimension of the tax base. Diagram 6 below depicts the different group taxation regimes applying the enterprise doctrine in terms of the tax base of a company as the taxable unit:

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\textsuperscript{14} The French worldwide group pooling regime is subject to very limited use; only about 10 groups of very large companies have been approved to be taxed under the regime: Michelsen, above note 7, at 58.

\textsuperscript{15} For a more detailed discussion of the Austrian regime, see Gerald Gahleitner and Stefan Ratzinger, "Austria: International Group Taxation: An Overview of Austria’s New Tax Incentive" (2005) November European Taxation 509. In particular, under the regime, all taxable income and losses of resident group members are aggregated regardless of the percentage of shareholding. However, for non-resident group members, only losses in proportion to the shareholdings of the Austrian parent company and group members are aggregated: ibid, at 510.
Diagram 6 Application of the enterprise doctrine: dimension of tax base of a company

**Enterprise doctrine**

**Key dimension: tax base**

- Company's taxable income and losses, adjusted for selected group member's taxable income or loss, or intra-group asset transfer
- Portion of country/bloc/worldwide group's taxable income or loss

- **Tax-free intra-group asset transfer** (India, Japan, Norway, Sweden and UK)
- **Organschaft** (Germany)
- **Water's edge FA** (provinces in Canada & states in U.S.)
- **Cross-border loss relief** (within EU)
- **Group loss relief** (Malaysia, New Zealand, Singapore and UK)
- **Group contribution** (Finland, Norway and Sweden)
- **Worldwide FA** (original California's FA regime)
The tax base of a company – which remains as a separate taxable unit – may be defined by applying the enterprise doctrine to different extents. It may be defined by taking into account certain tax attributes of other resident group companies in the following regimes:

(1) Tax free intra-group asset transfer.\(^{16}\)
India, Japan, Norway, Sweden and the UK have this regime.\(^ {17}\) Among these countries, India is unusual in having an intra-group asset transfer regime but without a regime dealing with intra-group loss offset. The intra-group loss offset regime is the more common regime, and either exists in isolation or coexists with an intra-group asset transfer regime.

(2) Group contribution:
Finland, Norway and Sweden have the group contribution regime, under which a profit-making group member can make a contribution to a loss-making member within a group of resident companies. The contribution is deductible for the former, and taxable to the latter, thus effectively achieving intra-group loss offset.

(3) Group loss relief
Malaysia, New Zealand, Singapore and the UK\(^ {18}\) have the group loss relief regime, under which losses may be transferred within a group of resident companies.\(^ {19}\)

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\(^{16}\) In this thesis, "intra-group asset transfer" refers to the tax attribute of a group taxation regime that allows tax free transfer of assets within a corporate group without the need of a corporate restructure. This definition excludes special regimes dealing with mergers and demergers, etc.

\(^{17}\) Since the introduction of the consolidation regime in Australia in 2002, asset transfers between resident group members were no longer eligible for roll-over relief. The scope of the regime has been restricted to asset transfers subject to capital gains tax in Australia involving non-resident group companies: Subdivision 126-B ITAA1997.

\(^{18}\) The UK’s group relief regime was introduced in 1967 to replace the 1953 provisions relating to subvention payments (under which intra-group loss offset was effectively allowed by a
(4) Organschaft.\textsuperscript{20}

Under Germany’s *Organschaft* regime, a parent company and its subsidiary can elect to have the taxable income or loss of the subsidiary transferred to the parent company, thus achieving intra-group loss offset at the parent company level. A profit-and-loss pooling agreement, which must have a minimum term of five years, is required between the parent and the subsidiary. Under the regime, a subsidiary remains as a separate entity for tax purposes and is required to file a tax return reporting a zero taxable income. The taxable income or loss of the subsidiary in general is calculated on a separate entity basis and intra-group transactions are not eliminated.\textsuperscript{21}

\textsuperscript{19} In Australia, the scope of the group relief regime has been substantially restricted since the introduction of its consolidation regime in 2002. In particular, the relief is now only available if one of the parties involved is an Australian branch of a foreign bank: Subdivisions 170-A & 170-B ITAA1997. In the UK, since 2006 the scope of the group relief regime in general has been extended to cover non-resident subsidiaries resident in the European Economic Area (“EEA”) under certain circumstances: IBFD, “Europe - Corporate Taxation - Country Analysis - United Kingdom (online database)” (2009) (available at www.ibfd.org), accessed on 10 December 2009, paragraph 8.1. For a brief discussion of the UK position on EEA losses, see John Tiley, *Revenue Law* (6th ed, 2008, Hart Publishing, Portland), at 959.


\textsuperscript{21} An unusual feature of the *Organschaft* is that pre-grouping losses of a subsidiary are suspended. They are not available to the parent company, but can be used by the subsidiary after it leaves the regime: Link, ibid, at 317. However, as the regime is not the focus of this thesis, the issue is not discussed in detail.
Organschaft applies not only to income tax, but also to business tax and value added tax. Furthermore, it pools both taxable income and losses of subsidiaries. It therefore represents a stronger application of the enterprise doctrine than the above three group taxation regimes.

(5) Water’s edge FA:
Provinces in Canada and most states in the U.S. have this regime. In contrast to the other regimes in this category, they are sub-national regimes. The tax base of a company is computed by apportioning the resident group’s tax base under the FA method. While the water’s edge FA regime may represent a stronger application of the enterprise doctrine in terms of the tax base allocation method, its application is restricted to the sub-national level and thus is not as comprehensive in scope as the other regimes.

The application of the enterprise doctrine may be pushed further by defining the tax base of a company in terms of a cross-border group. The group loss relief regime mentioned above may be expanded to cover losses of non-resident group members in a bloc. For example, it is possible to do so within the EU after the ECJ decision in Marks & Spencer. The tax base of a company may also be defined in terms of a worldwide group’s taxable income or loss. For instance, it may be adjusted under the profit-split method in the OECD Transfer Pricing Guidelines, taking into account the worldwide group’s taxable income or loss. In contrast, instead of a tailor-made adjustment provided under the profit-split method, the tax base of a company may be

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23 For example, the Canadian model works basically by first determining a group’s taxable income in Canada under federal tax rules, then allocating that amount to the provinces in accordance with a formula based on sales and wages. The precise legal structure of the group in the provinces is irrelevant for the allocation purpose: Bird, above note 1, at 340.

24 C-446/03. For example, see the response of the UK: above note 19.
determined by apportioning the worldwide group’s taxable income under the FA method. An example of this regime was the unitary taxation regime adopted in California and other states in the U.S. in the 1980s. However, the fierce objection from countries around the world and the ultimate withdrawal by the states proved that the regime was not acceptable to most countries.

Several observations can be made from the two diagrams above:

(1) Combination of models:
The models are not mutually exclusive. In practice, a country may adopt more than one model at the same time. For example, in Australia, the default model for corporate taxation is the traditional separate entity model, which represents a strict application of the separate entity doctrine. In addition, corporate groups may elect to be taxed under a consolidation regime, in which the enterprise doctrine is applied in terms of both taxable unit and tax base. A restrictive group loss relief regime is also available to banking groups. Italy also has several models operating simultaneously: the default separate entity model, the domestic group pooling regime (since 2008), the worldwide group pooling regime and the cross-border loss relief regime (applicable within the EU).

From a corporate group’s perspective, it may be subject to tax under different models in different countries. For example, a group with its parent company

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25 For a good discussion of the regime, see Daniel Sandler, “Slicing the Shadow - The Continuing Debate over Unitary Taxation and Worldwide Combined Reporting” (1994) 6 British Tax Review 572. When the “unitary movement” was at its height, the apportionment formulae of ten states included income of foreign group members: Bird, above note 1, at 343. All of those states eventually backed down mainly due to fear of loss of foreign investment: ibid. For a brief discussion of the subsequent change to “water’s edge” model, see Michael J McIntyre, “The Use of Combined Reporting by Nation States” (2004) 35 Tax Notes International 917, at 944.

26 Division 170 ITAA1997.
resident in France may be subject to tax in France under its worldwide group pooling regime. At the same time, its subsidiary in Canada may be subject to Canadian tax under the separate entity model. To avoid double taxation, the resident country of the parent company (in this case France) may provide a tax credit for the tax paid in the source country (in this case Canada), or exempt the foreign income from taxation.

(2) Residence concept: In theory, it is possible that the residence concept is irrelevant in a group taxation regime, if the worldwide tax base of a group is determined under a common set of tax rules endorsed by all countries, and is then allocated to each country under the FA method in which the residence concept has no influence. However, in practice, the concept of residence is always a critical constraint in the application of the enterprise doctrine. For instance, domestic consolidation regimes typically define the taxable unit to be the group of companies resident in a country. Even for the worldwide group pooling regimes in France and Italy, the residence concept occupies a dominant position, as only a parent company that is a resident of France or Italy can elect for the worldwide group taxation regimes. A multilateral regime is no exception. The proposed CCCTB regime in the EU defines the taxable unit to be a group of companies resident within the EU and the tax base to be the aggregate taxable income or losses of all these resident group companies.

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27 This thesis is not the place to discuss the corporate residence concept in detail. However, the concept is problematic, as “the idea of residence [of a corporation] is largely an effort to put flesh into fiction, to find economic and political substance in a world occupied by legal niceties. It is no accident that we call corporations doing business around the world ‘multinationals’”: Michael J Graetz, “The David R. Tillinghast lecture: Taxing International income: inadequate principles, outdated concepts, and unsatisfactory policies” (2001) 54(Spring) Tax Law Review 261, at 320.
(3) Ideas vs reality:
Many proposals have been made for a multilateral FA regime over the past decades. However, none has yet come close to actual implementation. There is no FA regime on a national level. The existing FA regimes are at the subnational level, for example, in Canada and the U.S.

A major obstacle for the implementation of a multilateral FA regime is the resistance of a country to surrendering its control over the taxation of companies. As can be seen from the above two diagrams, countries are relatively active and creative in the area of group taxation, as long as the regime does not expand across the border. The regimes are less common once they cross over jurisdictions. Further evidence of the political constraint is that all existing group taxation regimes are unilateral models, and are subject to the constraint of the residence principle. It is clear that the jurisdictional constraint is critical in the application of the enterprise doctrine. The constraint restricts definitions of the taxable unit and tax base, and the jurisdiction(s) adopting the tax base.

3.5 Application of the enterprise doctrine: key functions of a group taxation regime
An alternative classification of group taxation regimes can be made in terms of the two key functions that a group taxation regime is typically designed to achieve: intra-group loss offset and intra-group asset transfer. In this context, “intra-group asset transfer” refers to the tax attribute of a group taxation regime that allows tax free transfer of assets within a corporate group without the need of a corporate restructure.

28 The CCCTB project in the EU has been seen to be the (relatively) most promising proposal so far. However, its fate is uncertain and many commentators believe that it is bound to fail. See for example Joanna Faith, “EU Common Tax Base in Danger of Unravelling” (2008) June International Tax Review; and Joanna Faith, “Kovacs postpones CCCTB proposals” (2008) September International Tax Review.
The extent of application of the enterprise doctrine in a group taxation regime can be evaluated by whether it achieves one or both of the two key functions. The classification in terms of these two functions is depicted in Diagram 7 below:29

29 For clarity and to facilitate comparison on a country basis, the CCCTB project is not shown in the diagram as it is still under consultation and its implementation is uncertain; the water's edge FA regimes of Canadian provinces and states in the U.S. are not shown as they are sub-national regimes.
Diagram 7 Application of the enterprise doctrine: key functions of a group taxation regime

- **No regime for either key function**
  - Belgium, Canada, Hungary, South Africa & Switzerland

- **Only one regime for either domestic loss offset or asset transfer**
  - India & Japan
  - Finland
  - Malaysia, New Zealand & Singapore
  - Italy (since 2008), Luxembourg, Mexico, Poland & Portugal
  - Germany

- **Cross-border loss offset**
  - Worldwide loss relief
    - Austria, Denmark, France & Italy
  - within EU

- **Two separate regimes for loss offset and asset transfer**
  - Group contribution and asset transfer
    - Norway and Sweden
  - Group relief and asset transfer
    - UK

- **One regime for both loss offset and asset transfer**
  - Consolidation
    - Australia, France, Italy (before 2008), Japan, Netherlands, New Zealand, Spain, South Korea & U.S.

*Stronger application of the enterprise doctrine*
Some countries – including Belgium, Canada, Hungary, South Africa and Switzerland – do not have a specific regime allowing either intra-group loss offset or asset transfer. Corporate groups in those countries often have to resort to complicated tax planning structures to achieve similar tax outcomes, which is uncertain in practice and subject to challenge by tax authorities.\textsuperscript{31}

The majority of countries in this review have at least one group taxation regime catering for one or both of the two key functions. Regimes allowing intra-group loss offset are more common than those for intra-group asset transfer. In the 2004 IFA Congress Report, out of the 20 countries that reported at least one regime for either of the two key functions, 19 had an intra-group loss offset regime while only 12 had an intra-group asset transfer regime.\textsuperscript{32} A survey of the countries in December 2010 reveals no material change in the pattern.\textsuperscript{33} Most countries have the same regimes as in 2004. The exceptions noted include:

(1) Austria, which had \textit{Organschaft} in 2004, has replaced the regime with \textit{Unternehmensgruppe} in 2005 allowing cross-border loss offset;

(2) Poland, which was not included in the 2004 Report, has a group pooling regime allowing intra-group loss offset;

\textsuperscript{30} The Canadian government announced in its 2010 Budget that it would consider the introduction of a “formal system of loss transfer or consolidated reporting” with the intention “to improve the competitiveness of the tax system for Canadian businesses”, as it “has heard various concerns from the business community and from the provinces regarding the utilization of tax losses within corporate groups”: Minister of Finance, \textit{Budget 2010: Leading the Way on Jobs and Growth} (available at www.fin.gc.ca), at 386. This is followed by the release of a consultation paper in November 2010: Department of Finance (Canada), \textit{The Taxation of Corporate Groups – Consultation Paper} (available at www.fin.gc.ca).

\textsuperscript{31} For a general discussion of the common planning techniques, see Masui, above note 2, at 47-51.

\textsuperscript{32} Ibid, at 33-34.

\textsuperscript{33} The survey was done on 28 December 2010 on the IBFD databases: see note 4 above for detail of the databases used in the survey.
(3) Malaysia, which was not included in the 2004 Report, has a group relief regime;
(4) South Korea, which had no regime providing for either of the two key functions, introduced a consolidation regime in 2010; and
(5) Japan, which has already a consolidation regime since 2002, introduced an intra-group asset transfer regime for non-consolidated groups in 2010.\(^{34}\)

Two observations can be made at this point. First, once a group taxation regime is introduced, it tends to stay in the tax system. Major changes to the regime are unlikely.\(^{35}\) Second, the trend is an increasing application of the enterprise doctrine. More countries are implementing group taxation regimes while some replace an old group taxation regime with a new one that represents a stronger application of the doctrine.

Among the countries that have only one group taxation regime providing one of the two key functions, India is unique as it has a regime for intra-group asset transfer but not one for intra-group loss offset. For countries with one regime for intra-group loss offset, Germany’s Organschaft affects not only income tax but also business tax and value added tax.\(^{36}\) Therefore, it is regarded as

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\(^{34}\) The intra-group asset transfer regime, effective 1 October 2010, was introduced under the 2010 tax reform in Japan: IBFD, “Country Analyses - Japan - Corporate Taxation (online database)” (2010) (available at www.ibfd.org), accessed on 28 December 2010, paragraph 8.1. The regime in general applies to asset transfers between resident companies that are wholly-owned by either a resident company, a non-resident company or individuals: ibid; and PwC, Asia Pacific Tax Notes (June 2010) Issue 23 (available at www.pwccn.com), accessed on 29 December 2010, at 27.

\(^{35}\) An exception was reported in Canada where a consolidation regime was introduced in 1932 and abolished in 1952. Since then, the Canadian government has repeatedly considered adopting a formal group taxation regime, but so far has resisted the temptation “primarily based on concerns over complexity, administrative efficiency, and potential revenue loss, rather than tax policy”: Pierre Desloges & Patrick Marley, “Branch Report: Canada” in International Fiscal Association, Cahiers de Droit Fiscal International Volume 89b: Group Taxation (2004), at 217.

\(^{36}\) See footnote 22 above.
Chapter 3 Enterprise Doctrine – Practice

representing a stronger application of the enterprise doctrine than the other intra-group loss offset regimes such as group pooling, group contribution and group relief.

Another feature of the loss offset regimes is that as taxable income and losses of group companies are aggregated, intra-group transactions are often not eliminated. Examples include Germany’s Organschaft, New Zealand’s group loss relief regime, Sweden’s group contribution regime and Portugal’s group pooling regime. This feature implies a weaker application of the enterprise doctrine than a consolidation regime under which intra-group transactions are often eliminated.

The enterprise doctrine has been pushed further to allow cross-border loss offset in a few countries. However, it is less common than a regime restricted to loss offset among resident group companies. This reflects the general supremacy of the residence concept over the enterprise doctrine in most countries and also constraints imposed by the international tax norms. Furthermore, it is observed that all the countries with cross-border loss offset regimes are in the EU, suggesting a strong influence of the EU tax rules and especially ECJ decisions on domestic tax laws of the member states. For instance, the extension of Austria’s intra-group loss offset regime from a domestic to a cross-border basis is largely a response to the substantial influence of ECJ decisions (in particular, the Marks & Spencer case).

37 Link, above note 20, at 314.
40 See discussion in Chapter 2 Section 2.4.1.2.
Of the twelve countries that allow both intra-group loss offset and tax free intra-group asset transfer, nine of them – Australia, France, Italy, Japan, the Netherlands, New Zealand, Spain, South Korea and the U.S. – implement a consolidation regime to deal comprehensively with both tax attributes. Only three countries – Norway, Sweden and the UK – have separate regimes catering for the two key functions respectively.

### 3.6 Conclusion

The review and classification of the group taxation regimes in this chapter reveals a spectrum of different extents of application of the enterprise doctrines. Starting from the traditional position of treating a company as a separate taxable unit reporting its own taxable income or loss, the enterprise doctrine can be applied in two key dimensions: the taxable unit and the tax base. The definition of the taxable unit may be expanded to be a country group, a bloc group, or a worldwide group. The tax base may be defined in various ways to apply the doctrine, from transferring taxable income or loss between group companies to allocating the tax base of a group’s overall taxable income or loss under the FA method.

The review of the group taxation regimes in practice suggests that the application of the enterprise doctrine is subject to some important constraints. The constraint imposed by the residence principle is evident. A majority of group taxation regimes defines the taxable unit to be a group of resident companies, excluding non-resident group members. The tax base of a company under most group taxation regimes is similarly restricted and is

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41 Italy introduced a domestic consolidation regime in 2004 allowing both intra-group loss offset and tax free asset transfer. However, the policy of intra-group asset transfer was abolished in 2008, thus becoming a group pooling regime: see footnote 6 above. South Korea fills the place left by Italy as it has introduced a consolidation regime in 2010: IBFD, “Country Analyses - Republic of Korea - Corporate Taxation (online database)” (available at www.ibfd.org), accessed on at 20 July 2010.
defined in terms of a group of resident companies in a country. The residence principle is also critical in cross-border group taxation regimes. For example, the worldwide group pooling regimes in France and Italy are available only to groups with a parent company resident in France or Italy. The other key constraint on the application of the enterprise doctrine is jurisdictional resistance, which is possibly the most important obstacle to implement a multilateral group taxation regime under the FA method in practice.

Alternatively, group taxation regimes may be classified in terms of the two key functions that a group taxation regime is often designed to achieve: intra-group loss offset and intra-group asset transfer. This classification also reveals a spectrum of the application of the enterprise doctrine. At one end of the spectrum, some countries (for example, Canada) do not have a group taxation regime allowing either of the two functions. Corporate groups often have to engage in complicated tax planning attempting to achieve similar tax outcomes. At the other end of the spectrum, eight countries—Australia, France, Italy (before 2008), Japan, the Netherlands, New Zealand, Spain and the U.S.—have introduced a consolidation regime which achieves both functions. A consolidation regime represents not only a strong but also a widely accepted application of the enterprise doctrine. Some regimes—for example worldwide group pooling regimes in France and Italy—may have a wider definition of the taxable unit and tax base than consolidation. However, they are uncommon. Few countries have adopted the regime and there is no evidence to suggest that other countries are considering introducing one. Furthermore, the worldwide group pooling regimes are less comprehensive than a consolidation regime, as they cater only for intra-group loss offset, but not intra-group asset transfer. In summary, a consolidation regime represents

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42 South Korea introduced a consolidation regime in 2010. It is not analysed in detail in this thesis as little information is available yet on its detailed rules and actual implementation.
the strongest application of the enterprise doctrine to date that is also common in practice.

For the above reasons, consolidation regimes in the eight countries are the subject of the detailed comparative analysis in Part Two of this thesis. The purpose of the comparative study is twofold. First, the comparative study analyses and critically compares alternative policy options adopted in the eight countries dealing with the key structural elements of a consolidation regime, with the intention of identifying a model consolidation regime. Second, the consolidation regimes in the eight countries represent a spectrum of different extents of application of the enterprise doctrine, ranging from the pooling system (for example, in France) to the “asset-based” model in Australia. The comparative analysis provides an opportunity to answer the policy question of whether a stronger application of the enterprise doctrine necessarily implies a better regime on policy grounds.

Part Two of this thesis commences with the next chapter which analyses the policy objectives of consolidation regimes in the eight countries and investigates why the countries introduced a consolidation regime. The chapter also compares the alternative policy options for five key structural elements of a consolidation regime, namely the single entity concept, consolidation of group results, liability to tax, election to consolidate and the “all in” rule. The other five key structural elements of a consolidation regime – namely, definition of a group, treatment of pre-consolidation losses, treatment of consolidated group’s losses, treatment of assets and treatment of intra-group shares – are analysed in Chapters 5 to 8.
Chapter 4 Policy Objectives and Five Key Structural Elements

PART TWO

COMPARATIVE ANALYSIS OF KEY STRUCTURAL ELEMENTS OF CONSOLIDATION REGIMES

CHAPTER 4

POLICY OBJECTIVES AND STRUCTURAL ELEMENTS OF CONSOLIDATION

4.1 Introduction

This chapter reviews and analyses the policy objectives of consolidation regimes in Australia, France, Italy, Japan, the Netherlands, New Zealand, Spain and the United States. The aim is to understand why a country decides to deviate from the traditional separate entity doctrine and apply the enterprise doctrine in a consolidation regime.

1 For an earlier comparison of the policy objectives of consolidation regimes in Australia, New Zealand and the U.S., see Antony Ting, "Policy and Membership Requirements for Consolidation: A Comparison between Australia, New Zealand and the US" (2005) 3 British Tax Review 311. The analysis with respect to these three countries has been substantially updated and expanded in this chapter.
For the purpose of assessing how far the consolidation regimes apply the enterprise doctrine and how well they achieve their policy objectives, the chapter then proceeds to analyse and compare critically alternative policy options of the following five key structural elements of consolidation regimes:

(1) the single entity concept;
(2) consolidation of group results;
(3) liability to tax;
(4) election to consolidate; and
(5) the "all in" rule.

The other five key structural elements of a consolidation regime are more complex and are analysed in the following separate chapters:

- Chapter 5: Definition of a group;
- Chapter 6: Treatment of pre-consolidation losses and group losses;
- Chapter 7: Treatment of assets; and
- Chapter 8: Treatment of intra-group shares.

To facilitate cross-referencing between chapters, the comparative analysis of the key structural elements in this Part of the thesis is organised in alphabetical order of the countries.

4.2 Policy objectives: why allow consolidation?
Companies are in general treated as separate taxable units in the tax law. This reflects the application of the traditional separate entity doctrine, under which a company is treated as a separate entity. All the eight countries have decided to deviate from the doctrine and apply the enterprise doctrine in their
consolidation regimes. This begs the question of why they allow corporate
groups to form a consolidated group and file a single consolidated return.

In Chapter 2, it is argued that the application of the enterprise doctrine to treat
a corporate group as a single taxable unit is consistent with the tax policy
objectives of neutrality and competitiveness. The following material analyses
the driving force behind the introduction of a consolidation regime in the eight
countries. An overall evaluation of the policy objectives in the eight countries
is provided in Section 4.8 “Conclusion” below.

Australia
The consolidation regime in Australia was introduced in 2002 as part of the
business tax reform initiated by the Ralph Report published in 1999.2

The policy objectives of the consolidation regime were stipulated explicitly in
the tax law:3

- prevent double taxation of the same economic gain realised by a
  consolidated group,
- prevent a double tax benefit from an economic loss realised by a
  consolidated group,
- reduce the cost of complying with the tax law, and
- improve business efficiency by removing complexities and promoting
  simplicity in the taxation of wholly owned groups.

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Chapter 4 Policy Objectives and Five Key Structural Elements

The first two objectives imply an application of the enterprise doctrine\(^4\) while the last two focus on the policy objective of simplicity. Nevertheless, it is clear that the government has an equally important objective of anti-avoidance. In particular, the government states that (emphasis added):\(^5\)

[Consolidation] will address ... problems existing in the taxation of wholly-owned entity groups ... [including]:

- compliance and general tax costs;
- double taxation where gains are taxed when realised and then taxed again on the disposal of equity;
- \textit{tax avoidance} through intra-group dealings;
- \textit{loss cascading} by the creation of multiple tax losses from the one economic loss; and
- \textit{value shifting} to create artificial losses where there is no actual economic loss.

It has been observed that the consolidation regime “is \textit{at base an integrity measure}, designed to stop taxpayers exploiting mismatches” (emphasis added).\(^6\)

Intuitively, one may question the effectiveness of the regime in achieving an “anti-avoidance” objective, given that a corporate group will be subject to the

\(^{4}\) These two objectives reflect the determination of the government to deal with the dual cost bases issue in corporate groups. For detailed discussion of the issue, see Chapter 8 “Treatment of Intra-group Shareholdings”.


regime only if it elects to consolidate. A rational taxpayer is unlikely to elect to be taxed under an anti-avoidance regime.\(^7\) Furthermore, as the consolidation regime in Australia requires an ownership threshold of 100 per cent, a company may avoid the regime by deliberately failing the “100% ownership” test.\(^8\)

Furthermore, the enterprise doctrine contradicts the anti-avoidance objective with respect to the definition of a group. On one hand, the enterprise doctrine implies that the ownership requirement between group companies should be strict (for example 100% ownership) to ensure that only groups under the full control of the parent companies are eligible for consolidation. On the other hand, an anti-avoidance objective would require the definition of a group to be much wider (for example a simple majority of more than 50% ownership). This inherent conflict dictates failure to achieve both objectives at the same time. It appears that the current regime – with the 100 per cent ownership requirement – is designed at the expense of the anti-avoidance objective. The anti-avoidance objective perhaps should be viewed as an incidental consequence of the regime for groups electing to consolidate.\(^9\)

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\(^7\) In comparison, the original consolidation regime in the U.S. back in 1917 was introduced primarily as an anti-avoidance measure and was imposed on the targeted company groups by the tax authorities: Kevin M Hennessey et al, The Consolidated Tax Return: Principles, Practice & Planning (2003, RIA, New York), paragraph 1.02[2].

\(^8\) For detail of the ownership requirement, see Chapter 5 “Definition of a Group”. Of course, the taxpayer cannot escape that easily from every anti-avoidance rule in Australia. In particular, companies are in general subject to detailed and complex rules on duplication of both realised and unrealised losses in Division 165 ITAA 1997. There is also a general regime targeting value shifting in Part 3-95 ITAA 1997. The very existence of these anti-avoidance rules begs the question whether the consolidation regime should have an anti-avoidance motive on loss cascading and value shifting as its objectives at all. Over-arching specific anti-avoidance rules are the general anti-avoidance provisions of Part IVA of the Income Tax Assessment Act 1936 (“ITAA 1936”).

\(^9\) Besides the government, it appears that tax practitioners were also confused about the policy objectives. One prominent tax practitioner, who had been involved substantially in the consultation and design process of the consolidation regime, argued that the “view of some tax practitioners that Australia’s tax consolidation regime is there to provide a wonderful benefit
The fact that the consolidation regime has been very popular among corporate groups\textsuperscript{10} and "there have not been too many complaints"\textsuperscript{11} casts doubt on whether the Australian government has achieved the anti-avoidance objective. The regime has provided significant tax benefits to corporate groups, as corporations "have been congratulating themselves on the higher cost base of their assets and their ability to utilise previously unusable losses".\textsuperscript{12} It is difficult to comprehend that an effective anti-avoidance regime would have such beneficial effects to and favourable reception by the business communities.

No other country has anti-avoidance as a major policy objective of its consolidation regime. This is a strong indication that most countries believe that an elective consolidation regime would not serve well as an anti-avoidance measure.

**France**

France introduced its first consolidation regime in 1971.\textsuperscript{13} Approval of the tax

\textit{for their clients is flawed. It is at base an integrity measure, designed to stop taxpayers exploiting mismatches" (emphasis added): Lehmann, above note 6, at 265.}

\textsuperscript{10} In 2005, about 4,000 groups have elected to consolidate 30,000 subsidiaries: Michael D’Ascenzo, “Consolidation: the Intent of the Consolidation Regime” (Paper presented at the Taxation Institute of Australia Consolidation Symposium, 19-20 May 2005).

\textsuperscript{11} Lehmann, above note 6, at 291.

\textsuperscript{12} Ibid. The issues of utilisation of pre-consolidation losses and cost base of assets are discussed in Chapters 6 “Treatment of Losses” and 8 “Treatment of Assets” respectively.

\textsuperscript{13} Frank Le Mentec, “French Tax Group Regimes” in The European Union and Group Relief: How will the Marks & Spencer Case Impact? (Special Report) (2006, BNAI, Washington), at 3. France has two consolidation regimes: domestic and worldwide. The latter applies to corporate groups controlled by a French parent company, including its overseas subsidiaries. The worldwide consolidation regime was introduced even earlier in 1965, but its use is very restricted. The French government has approved only about ten of France’s most important groups to be taxed under this regime: IBFD, “Country Analyses - France - Corporate Taxation (online database)” (available at www.ibfd.org), accessed on 28 December 2010, paragraph
authority was required before a group could consolidate. The policy objectives of the regime were to treat subsidiaries as branches of the parent company, and to facilitate group reorganisation.\footnote{Jose André Borrat & Alain Bassière, “Branch Report: France” in International Fiscal Association, Cahiers de Droit Fiscal International Volume 89b: Group Taxation (2004), at 274-275.} In other words, the original consolidation regime in France reflected an application of the enterprise doctrine while also served to achieve the policy objective of competitiveness.

The tension between the enterprise doctrine and anti-avoidance concerns was obvious in the regime. It was of very limited use due to the strict requirement that the French tax authorities would not approve a group to consolidate if the main purpose of consolidation was for the benefit of intra-group loss offsets.\footnote{Mentec, above note 13, at 3.}

The old consolidation regime was replaced by a more liberal regime in 1988, under which corporate groups can elect to consolidate and approval by tax authorities in general is no longer required.\footnote{Ibid.} This regime has proved to be quite popular. About 10,000 French groups have elected to be taxed under this regime.\footnote{Ibid. In contrast, there were only about fifty groups that were taxed under the old domestic consolidation regime and the worldwide consolidation regime back in 1987: Pierre Knoepfler and Jack Anderson, “France: Towards a Real Group Tax Harmonization” (1988) 28(6) European Taxation 171, at 171.}

The policy objectives of the current consolidation regime are basically the same as the old regime. It aims “to promote fiscal neutrality among different
business structures and to increase French companies’ competitiveness with their foreign counterparts". The objectives imply the application of enterprise doctrine by providing a neutral tax treatment to subsidiaries and branches. The policy objective of competitiveness also features dominantly in France.

**Italy**

The domestic consolidation regime in Italy was one of the most important regimes introduced in its corporate tax reform in 2004. The regime was introduced together with two other group taxation regimes: the worldwide consolidation regime which applies to corporate groups with foreign subsidiaries; and the consortium relief which basically treats companies as look-through entities.

The main objective of introducing the consolidation regime was to foster the overall competitiveness of the Italian tax system, and promote foreign

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18 Knoepfler & Anderson, ibid, at 171. In respect of treating a corporate group as one single entity, the tax law was ahead of the commercial law and accounting rules in France as the latter did not have a group concept yet in 1988: ibid, at 174.

19 This tax reform was undertaken in conjunction with a major corporate law reform, which introduced new corporate governance rules for corporate groups, also effective from 1 January 2004. For instance, foreign multinational groups would have much more flexibility in the use of corporate vehicles under the new rules: for more details, see Massimo Giaconia, “Branch Report: Italy” in International Fiscal Association, Cahiers de Droit Fiscal International Volume 89b: Group Taxation (2004), at 369-370, & 384-385. Before 2004, Italy had a “de facto tax consolidation” regime, under which excess imputation credit received by a loss-making parent company could be surrendered back to the profitable subsidiary. The latter could then use the tax credit to offset against its own income tax liability. This regime was removed upon introduction of the consolidation regimes in 2004. For more information about the old regime, see ibid, at 375-376.

20 Article 130, Testo unico delle imposte sui redditi (“Income Tax Code” of Italy) (“TUIR”). In general, the regime is much stricter than its domestic counterpart, e.g. the “all in” rule applies to ensure that all eligible subsidiaries of the parent company must join the consolidation. For more detail of the regime, see Giaconia, ibid, at 386-387.

21 Articles 115 & 116, TUIR.
investments in Italy.\[^{22}\] In fact, the regime was “inspired by the [group taxation] regimes of other [EU] Member States, for example, those applying in Denmark, France, Germany and Spain”\[^{23}\]. The policy objective is consistent with the main theme of the 2004 tax reform, namely to “create a neutral ... eye-catching and competitive tax system” (emphasis added).\[^{24}\] In summary, competitiveness is the predominant policy objective behind the introduction of the consolidation regime in Italy.

It appears that the enterprise doctrine does not feature as a dominant policy objective of the consolidation regime. This helps to explain why, as is analysed below and in other chapters, the Italian consolidation regime represents a rather weak application of the doctrine. In fact, it was reduced to a group pooling regime in 2008 when the policy of tax free intra-group asset transfer was abolished.\[^{25}\]

**Japan**

The consolidation regime in Japan was introduced in 2002 as part of the tax reform aiming to revitalise the Japanese economy.\[^{26}\] Its structure “draws heavily on the French and U.S. systems”.\[^{27}\] The regime was designed to “enable strategic reorganisation of Japanese corporations ... by which they could become more competitive and the Japanese economy would be revived

\[^{22}\] Giaconia, above note 19, at 388.


\[^{25}\] For more detailed discussion of the policy change, see Chapter 7 Section 7.3.


with a new structure” (emphasis added). Similar to Italy, competitiveness is the dominant policy objective of the consolidation regime.

The introduction of the consolidation regime in Japan was a response of the government to the “growing pressure from business circles”. In the late 1990s, more businesses moved to a holding structure as the Antitrust Law lifted prohibition on pure holding companies, and corporate and labour laws were amended to facilitate corporate restructuring. The consolidation regime was introduced partly in response to the wishes of the business communities.

“Revenue neutrality” was also an important policy objective of the regime. The government believed that the introduction of the consolidation system would decrease revenue. To counter the revenue loss, an additional two percent surtax was imposed on consolidated group for the first two years since the introduction of the regime.

The Netherlands
The consolidation regime in the Netherlands, known as “fiscal unity”, has a long history and demonstrates a clear recognition of the enterprise doctrine.

28 Komamiya, above note 26, at 393.
29 Masui, above note 27, at 36.
30 Ibid.
32 Komamiya, above note 26, at 393. The Ministry of Finance estimated the revenue loss to be about JPY 800 billion in 2002: Aoki, ibid, at 327. This is especially significant given that “with the accumulated public debt, Japan’s fiscal position relative to GDP is the worst of the developed countries”: ibid, at 324.
33 Komamiya, above note 26, at 397. Some businesses had alleged that the surcharge discouraged consolidation and should not be imposed. However, the government decided to impose the tax after its survey among corporations found that the surcharge would not have significant adverse effect on the take-up rate of the consolidation regime. For a summary of the survey result, see Aoki, above note 31, at 327.
When profits tax was first introduced in the Netherlands in 1940, it was accompanied by the “fiscal unity regulation” under which wholly-owned corporate groups were “subject to tax as a single entity”. The regulation was designed to recognise “the special position of parent companies heading [their 100% subsidiaries and] to create the possibility of combining profits and losses of [those] entities ... as a single result in the levy of corporate tax”. The regulation was incorporated into the Corporate Tax Act in 1970.

The fiscal unity regime was essentially in force without substantial changes until major amendments were made in 2003. For instance, the 100 per cent ownership threshold was relaxed and reduced to 95 per cent.

**New Zealand**

The policy objectives of group taxation regimes in New Zealand have changed over time. New Zealand had initially introduced a group taxation regime primarily with an anti-avoidance objective, as corporations were taxed at progressive tax rates. The regime allowed the tax authorities to tax a corporate group as one single company if.

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35 Ibid.

36 The old Article 15, CTA 1969.

37 Vries, above note 34, at 462.

Chapter 4 Policy Objectives and Five Key Structural Elements

- the companies were more than 50 per cent commonly owned, and
- the companies were formed as separate companies to reduce tax.

When the corporate progressive tax rates were abolished in 1976, the group taxation regime lost its anti-avoidance focus. However, the regime was retained and modified to become the current group loss relief regime.

The consolidation regime in New Zealand was introduced in 1992. One of its original objectives was to serve as a compensation for the proposed removal of the intra-group dividend exemption regime, which had been applied since income tax was first introduced in New Zealand. In the end, the consolidation regime was introduced while the dividend exemption regime was maintained.

New Zealand’s consolidation regime has a clear objective of applying the enterprise doctrine. The government stated clearly that the reasons for introducing the consolidation regime was “to treat those corporate groups for tax purposes more in accordance with economic substance, rather than the legal form of their business organisation” (emphasis added) and “to simplify the tax rules applying to those corporate groups”.

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39 Plunket & McKinley, ibid, at 488.
41 CCH New Zealand, ibid, paragraph 502-250.
42 Ibid. The government stated another reason for the regime, namely to reduce the adverse effect of the proposed removal of intercorporate dividend exemption: see footnote 40 above. This objective became irrelevant when the government finally decided not to remove the exemption: see IRD, Tax Information Bulletin Vol. 4, No. 5, p.3.
The enterprise doctrine sits well with the general tax policy principle in New Zealand that the tax system should be neutral to business forms.\textsuperscript{43} The imposition of tax should be the same for a company to undertake a business itself, or by a separate subsidiary. It is observed that the consolidation regime, together with other grouping regimes (for example, the group loss relief regime), is consistent with the principle and creates an income tax system that imposes "few obstacles ... to the effective functioning of corporate groups".\textsuperscript{44}

\textbf{Spain}

Similar to New Zealand, the policy objectives of group taxation regimes in Spain have changed over time. Before the consolidation regime was formally introduced in Spain, there were isolated pieces of legislation in 1942, 1947 and 1967 to tax a corporate group as one taxpayer.\textsuperscript{45} Their objectives were primarily anti-avoidance, as corporate tax was levied at progressive tax rates in those years.

The first consolidation regime in Spain was introduced in 1977 with the primary objective "to avoid double taxation in corporate groups".\textsuperscript{46} This implies an application of the enterprise doctrine. However, the regime had never been applied in practice as "there was no further implementing legislation".\textsuperscript{47}

\footnotesize
\begin{itemize}
  \item \textsuperscript{43} Plunket \& McKinley, above note 38, at 506.
  \item \textsuperscript{44} Ibid, at 507.
  \item \textsuperscript{46} Ibid, at 613.
  \item \textsuperscript{47} Ibid.
\end{itemize}
The current consolidation regime is widely used and has a different objective. It is designed “to facilitate optimum structuring and size of enterprises, and … to improve competitiveness and promote economic growth”, reflecting a dominant policy objective of competitiveness in the regime.

**The United States**

The consolidation regime in the U.S. has the longest history and has experienced several changes of policy objectives. It was first introduced in 1917 as an anti-avoidance measure targeting groups that sought to lower the tax rates on profits subject to graduated World War I excess profits tax. In contrast to Australia, the regime was mandatory, consistent with its anti-avoidance objective.

In 1921, the excess profits tax was abolished. The consolidation regime lost its anti-avoidance focus and became an optional “privilege”. The regime was abolished for most corporations from 1934 until World War II. In 1941, with the imposition of World War II excess profits tax, the consolidation regime was reinstated, but subject to an additional penalty tax of 2 per cent. With the repeal of the 2 per cent penalty tax in 1964, together with new

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48 Ibid.


50 The legislation stipulates that it is a "privilege" to make a consolidated return: IRC Section1501. See also Eustice, ibid, paragraph 13.40.

51 Eustice, ibid. The 2 per cent surcharge was imposed since 1934, originally justified by "welfare (i.e. anti-holding company) reasons as [well as] technical argument stressing tax savings": Samuel Blitman, "Consolidated returns in the federal tax system" (1955) 8(3) *National Tax Journal* 260, at 260 and 273.
legislation restricting the benefits of multiple corporations,\textsuperscript{52} the consolidation regime has become very popular among corporate groups.\textsuperscript{53}

The U.S. consolidation regime fails to apply the enterprise doctrine consistently.\textsuperscript{54} The policy objective of consolidation regime has been described as a pendulum swinging between anti-avoidance and the enterprise doctrine.\textsuperscript{55} As discussed above, the introduction of the regime in 1917 was driven by anti-avoidance concerns. The policy objective lost its anti-avoidance emphasis in 1921 when the regime became elective. The pendulum swung back to focus on anti-avoidance in 1941 when the 2 per cent additional penalty tax was imposed on consolidated groups. The enterprise doctrine appeared to regain the upper hand in 1964 when the penalty tax was abolished, as it was observed that:\textsuperscript{56}

\textsuperscript{52} Eustice, above note 49, paragraph 13.40. For a brief discussion of the various measures adopted, see ibid, Chapter 13, Part A. For instance, IRC Section 1561 limits a group of corporations (as defined in Section 1563, which in general includes a group eligible to consolidate) to only one set of progressive income tax rate brackets under Section 11(b)(1). In other words, such groups could claim only one set of progressive rates regardless of whether they choose to consolidate or not. That implies such groups are no longer discouraged to consolidate due to the previously available benefits of multiple corporations.

\textsuperscript{53} Hennessey, above note 7, paragraph 1.01. The popularity of the regime can be measured by the percentage of the total gross receipts of all corporations included in consolidated returns: Dubroff, above note 49, paragraph 1.02. The percentage increased from about 25\% in the mid-1960s to more than 40\% by the early 1970s. The current percentage has increased to more than 60\%. For instance, according to the IRS Statistics for 2005 (available at www.irs.gov accessed on 21 April 2009), over 46,000 corporate groups filed consolidated returns. Though representing only 0.8\% of the total number of corporate tax returns filed, consolidated groups accounted for 64\% of gross receipts of all corporations.

\textsuperscript{54} It has been suggested that the enterprise doctrine might have been the underlying reason for the introduction of the consolidation regime, as the “original impetus for the consolidated return is believed to be rooted in the recognition that controlled groups effectively operate as a single business unit” (emphasis added): Giovanna Terese Sparagna, “Branch Report: United States” in International Fiscal Association (ed), Cahiers de Droit Fiscal International Volume 89b: Group Taxation (2004) 711, at 715. However, given the abuses regarding the progressive excess profits tax at that time, the anti-avoidance objective appeared to be the dominant driving force behind the introduction of the regime.

\textsuperscript{55} Hennessey, above note 7, paragraph 1.01.

\textsuperscript{56} Ibid.
Both Congress and the Treasury began to realise that there was a sound economic basis for permitting affiliated groups to file one consolidated return. In substance, there was little distinction between a corporation that chose to conduct its business by means of divisions and another corporation that preferred to operate ... through subsidiaries.

Despite this change in attitude, the government has always been vigilant about avoidance potential offered by the consolidation regime. For example, the ownership requirement was tightened in 1984 to include not only 80 per cent voting rights but also 80 per cent value of shares. The policy change reflects the long standing belief of the U.S. government that allowing corporate groups to consolidate has inherent fundamental problems, namely the danger of abuse when separate legal entities are treated as one enterprise.

The U.S. experience illustrates vividly the constant tension between the enterprise doctrine and the policy objective of anti-avoidance. The “pendulum swings” of policy objectives also help to explain why the U.S. consolidation regime fails to apply consistently the enterprise doctrine.

South Korea

Though South Korea is not one of the countries being studied in detail in this thesis, it is interesting to review briefly the policy objectives of its

57 Hennessey, above note 7, paragraphs 1.01 & 1.18. For a detailed account of the historical development of the U.S. consolidation regime, see ibid, Chapter 1. For a brief discussion of the tax planning opportunities before the change, see Lloyd W Herrold, “Consolidated Return Considerations in a Period of Transition” (1970) 22(3) Tax Executive 177, at 178.

58 Herrold, ibid, at 177.
consolidation regime which is introduced in 2010.\textsuperscript{59}

The regime was proposed by the Ministry of Strategy and Finance in September 2008, and was intended to have the following effects:\textsuperscript{60}

(a) to give flexibility to corporate groups to cope with the constantly changing business environment;

(b) to improve the Korean corporate tax system by imposing taxes based on economic substance.

This suggests that the consolidation regime in South Korea has dual objectives: competitiveness and the application of the enterprise doctrine, reinforcing the international trend of the dominancy of the policy objective of competitiveness with respect to the introduction of consolidation regimes.

After reviewing the policy objectives of the consolidation regimes, the following sections analyse and compare alternative policy options of the eight countries with respect to five key structural elements of a consolidation regime, namely the single entity concept, consolidation of group results, liability to tax; election to consolidate and the “all in” rule.

\textsuperscript{59} The legislation of the regime is contained in Article 76-8 to 76-22 Corporation Tax Law ("CTL"): IBFD, "Country Analyses - Republic of Korea - Corporate Taxation (online database)" (available at www.ibfd.org), accessed on 28 December 2010, paragraph 30.4. The regime apparently has undergone a long period of consideration by the government: it was reported back in 2004 that the "topic is currently under heated discussion and the government plans to introduce the system as early as 2005": Masui, above note 27, at 28.

4.3 The single entity concept

Under the enterprise doctrine, a corporate group under the common control of a parent company should be treated as one single taxable unit for income tax purposes. Putting this deceptively simple statement into practice proves to be a difficult balancing act between conflicting policy objectives and constant tension between the enterprise doctrine and the separate entity doctrine. The issue is how far the enterprise doctrine should be applied to treat a corporate group as a single taxable unit and whether the group should be treated as a distinct taxpayer separate from all group members (including the parent company). This begs the question of whether the group should be treated as an aggregate of all the group members, with group members to a large extent maintaining individual identities; or the group be treated as comprising the parent company only, with its subsidiaries deemed to be “absorbed” into the parent company, becoming branches of the parent company.

The application of the enterprise doctrine in terms of the single entity concept in the eight consolidation regimes is analysed and compared in the following material.

Australia

In Australia, the single entity concept – known as the “single entity rule” (“SER”) – is clearly stipulated in the tax law. All subsidiary members of a consolidated group are treated as “parts of the head company of the group, rather than separate entities ...” (emphasis added). Consequences of the SER include not only the typical implications of consolidation – for example, filing of a single income tax return for the group, a common tax accounting period for all group members and elimination of intra-group transactions – but also

61 Section 701-1 ITAA 1997.
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the deemed "disappearance" of subsidiaries for income tax purposes. The latter implication represents the strongest single entity concept among the eight countries.

The SER is supported by two more deeming provisions: the "entry history rule" and the "exit history rule". Both rules potentially can have far reaching tax consequences. Under the entry history rule, "everything that happened in relation to [a subsidiary] before it became a subsidiary member [of a consolidated group] is taken to have happened in relation to the head company" (emphasis added). It implies that the tax history and attributes of a subsidiary are deemed to be those of the parent company. This rule is necessary as, under the SER, a subsidiary is deemed to have "disappeared" upon consolidation.

When a subsidiary leaves a consolidated group, the deemed positions under the entry history rule have to be reversed. The exit history rule serves that purpose by deeming that "everything that happened ... to any ... asset ... while it was that of the head company ... is taken to have happened ... to it as

62 EM to May 2002 Consolidation Act, paragraphs 2.17 to 2.21.
63 Section 701-5 ITAA 1997.
64 One may argue that the entry history rule has pushed the logic of the enterprise doctrine too far. It implies that when a group elects to consolidate, the enterprise doctrine applies not only from the time of consolidation, but also before consolidation actually commences. This creates confusion over the transition between the two doctrines and arguably has applied the enterprise doctrine too early. The practical consequence is that it makes the regime unnecessarily complex. For example, strictly according to the entry history rule, pre-consolidation losses of a subsidiary would be deemed to be those incurred by the parent company. It would imply that those losses could be utilised by the parent company as its own losses. A significant impact on tax revenue would be expected. The solution is a specific exception to the entry history rule and the invented concept of "available fraction" which is both problematic and complex. For more detailed discussion of these issues, see Chapter 6 Section 6.2.1. The entry history rule is one of the major review items in the post-implementation review of the consolidation regime: Board of Taxation, Post-implementation Review into Certain Aspects of the Consolidation Regime: Position Paper ("Position Paper") (2010) (available at www.taxboard.gov.au), Chapter 2.
if it had been an … asset of the [leaving subsidiary].65 This completes the consolidation cycle of a subsidiary under the single entity rule.66

Similar to the “absorption” concept in the old fiscal unity regime in the Netherlands, a problem of the SER is that the tax law does not explain clearly what it means. The law stipulates in very simple terms that under SER, subsidiaries are taken to be parts of the head company. Unless other parts of the consolidation regime stipulate the tax implications,67 it is open for interpretation.68 The strong SER has proved to be problematic to implement in practice. After seven years of implementing the SER, the Australian tax authorities are still struggling to understand fully its implications.69

France

The French consolidation regime is a pooling system.70 During consolidation,
each group member is still required to prepare and submit its own tax return.\(^{71}\) The parent company is responsible for the aggregation of the taxable income and losses of all group members (subject to adjustments including intra-group transactions) to arrive at the group’s taxable income or loss.\(^{72}\)

The French regime reflects a relatively strong influence of the separate entity doctrine even under consolidation. The requirement that each group member has to prepare its own tax return during consolidation suggests that each group member continues to maintain to a large extent its separate entity status.\(^{73}\)

**Italy**

Similar to France, the Italian consolidation regime is a pooling system. The group’s consolidated taxable income or loss in general is computed as the algebraic sum of the total taxable income and losses of all group members.\(^{74}\) Each subsidiary is required to prepare its own tax return and forward it to the parent company for the latter to prepare the consolidated tax computation.\(^{75}\)

The single entity concept in Italy’s consolidation regime suffered a serious setback in 2008 when the “tax neutral” treatment of intra-group asset transfer was abolished. Intra-group asset transfers among consolidated group members are now subject to immediate taxation in Italy. The consolidation regime has been effectively reduced to a group pooling regime which provides for intra-

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\(^{71}\) Article 223A Code général des impôts ("General Tax Code" of France) ("CGI").

\(^{72}\) Article 223B CGI. The intra-group transactions that are neutralised at the consolidation level include intra-group asset and share transfers, intra-group dividends, and intra-group provisions of bad and doubtful debts that are deductible at the group member’s level: IBFD, “Country Analyses - France - Corporate Taxation (online database)” (available at www.ibfd.org), accessed on 28 December 2010, paragraph 8.2.1.2.2.

\(^{73}\) Knoepfler & Anderson, above note 17, at 173.

\(^{74}\) Article 118(1) TUIR.

\(^{75}\) Article 121 TUIR.
group loss offset but not tax free intra-group asset transfers.

This policy change represents a significant departure from the enterprise doctrine. It also contradicts the policy objective of competitiveness. The significant policy change in a few years time since its introduction in 2004 indicates a relatively weak influence of the enterprise doctrine on the regime.

**Japan**

The tax law does not stipulate explicitly a single entity approach under the consolidation regime. Nevertheless, a consolidated group is basically treated as a single entity. The parent company of a consolidated group is treated “as the taxpayer of the group” for the purposes of corporate income tax.

The consolidation regime in Japan is also a pooling system. The parent company calculates the group’s taxable income or loss by aggregating tax results of the group members, and prepares and submits a consolidated tax return for the group. Each group member is still required to prepare and submit an individual tax return to its local tax office.

**The Netherlands**

The consolidation regime in the Netherlands, known as the “fiscal unity”

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77 Article 4-2 Corporation Tax Act (“CTA”).

78 Article 81 CTA.

79 Komamiya, above note 26, at 396.
regime, adopts a strong single entity concept. The tax law stipulates that if a parent company and its subsidiary elect to consolidate, the subsidiary’s activities and assets are deemed to be those of the parent company and tax is levied on the two companies as if they were a single taxpayer.\textsuperscript{80}

Before 2003, the single entity concept was applied differently. A subsidiary was treated as having been “absorbed” by the parent company. The exact meaning of “absorption” was controversial.\textsuperscript{81} It was unclear whether a consolidated subsidiary would still be eligible for treaty benefits.

The amendment of the tax law in 2003 replaced the “absorption” concept by the deemed attribution of assets and activities. The revised legislation also stipulates explicitly that the subsidiary remains subject to corporate tax, thus ensuring that the company remains relevant for the application of tax treaties.\textsuperscript{82}

\textit{New Zealand}

New Zealand adopts a relatively strong single entity concept in its consolidation regime, but not to the same extent as Australia does. In general, a consolidated group of companies is treated “as if they were a single company”.\textsuperscript{83} Each consolidated group has its own tax file number that is separate from that of its individual members.\textsuperscript{84}

\begin{footnotesize}
\textsuperscript{80} Article 15(1) Wet op de vennootschapsbelasting 1969 (“Corporate Income Tax Law of 1969” of the Netherlands) (“Vpb”).
\textsuperscript{81} For a brief discussion of the controversy, see Vries, above note 34, at 465-467.
\textsuperscript{82} Vries, above note 34, at 467.
\textsuperscript{83} Section FM 2(1) Income Tax Act 2007 (“ITA2007”).
\end{footnotesize}
The consolidation regime in New Zealand is a pooling system. Each group member must calculate its taxable income or loss, subject to various adjustments for consolidation purposes.\(^{85}\) Income and expenditures arising from intra-group transactions are in general ignored under consolidation.\(^{86}\) The group’s consolidated taxable income or loss is the sum of the taxable income and losses of its group members.\(^{87}\)

When calculating the taxable income of a group member for consolidation purposes, measures are in place to ensure that a consolidated group is generally liable to income tax as if it were a single company. Income derived by a group member is treated as taxable if the income would be taxable to “the consolidated group if it were one company ... “, even though it would otherwise be non-taxable.\(^{88}\) Similar explicit rules apply to expenditures.\(^{89}\) These rules reflect a strong application of the enterprise doctrine.

Despite explicitly stipulating an application of the enterprise doctrine, the tax law is also very clear that, in contrast to the position in Australia, shares of a consolidated group member are not deemed to have disappeared. Instead, for the purposes of applying the consolidation rules to other provisions of the tax law, shares of a consolidated group – which is treated as a single company under the consolidation regime – are deemed to be referring to all the shares of consolidated group members.\(^{90}\)

\(^{85}\) Section FM 3(2) ITA 2007.
\(^{86}\) Sections FM 8 & 10 ITA2007.
\(^{87}\) Section FM 3(1) ITA2007.
\(^{88}\) Section FM 9 ITA2007. The rule is particularly important in New Zealand which in general does not impose tax on capital gains.
\(^{89}\) Sections FM 11 & 12 ITA2007.
\(^{90}\) Section FM 6(2) ITA2007.
Spain

The tax law in Spain stipulates that a consolidated group is considered to be a taxable person. The parent company represents the group in all tax matters including preparation and submission of consolidated tax returns.

The regime is also a pooling system. Despite no tax payment being made, each group member is still required to prepare and submit individual tax returns. Similar to France and Italy, it reflects a relatively strong influence of the separate entity doctrine.

The United States

The U.S. regime fails to have a consistent single entity concept. Instead of stipulating a principle under which a consolidated group is to be treated, the tax law provides that the Treasury "shall prescribe such regulations . . . in order that the tax liability of any affiliated group of corporations making a consolidated return . . . may be returned, determined, computed, assessed, collected and adjusted . . .".

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91 Section 65(1) Ley del Impuesto sobre Sociedades ("Corporate Income Tax Law" of Spain) ("LIS").

92 Section 65(3) LIS.

93 For instance, the Regulations governing intra-group transactions state explicitly that the rules treat consolidated group members "as separate entities for some purposes but as divisions of a single corporation for other purposes": Reg. 1.1502-13(a)(2). In contrast, the elective check-the-box regime in the U.S. effectively grants certain groups a true single entity status. It is proving to be a useful tax planning tool by giving such groups de facto consolidation treatment and avoiding the complex consolidation regulations at the same time. Detailed discussion of the regime is beyond the scope of this thesis. For a brief discussion of the regime, see Eustice, above note 49, paragraph 13.014[c].

94 Inland Revenue Code ("IRC") Section 1502.
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Unfortunately, the regulations are extremely complicated, and fail to lay down a clear and consistent principle on the treatment of a consolidated group. The first set of regulations in 1955 "tended to treat the affiliated group more as a single entity"; the second set in 1966 tended to lean towards the "separate entity" approach more; subsequent revisions swung back towards the "single entity" approach.

The consolidation regime in the U.S. is a pooling system. Separate taxable income or loss of each group member is first calculated in accordance with the rules applicable to the individual company, before aggregating together to arrive at the consolidated taxable income of the group. Subject to certain modifications (including intercompany transactions), separate taxable income of a group member is computed "in accordance with the provisions of the Code covering the determination of taxable income of separate corporations" (emphasis added). It appears that characterisation of transactions is determined based on the circumstances of the individual member, and not affected by consolidation. In this respect, the U.S. regime reflects a relatively strong influence of the separate entity doctrine. However, when the

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96 Eustice, ibid. A tax case in 2001 seems to confirm that at least the calculation of consolidated net loss should be based on the single entity approach: United Dominion Industries, Inc. v United States (2001) 532 U.S. 822. The Supreme Court of the United States ruled that the taxpayer's single entity approach to calculate one category of the consolidated losses of the affiliated group was correct. The ambiguity of the issue in the U.S. was clearly demonstrated by the fact that decisions were reversed every time the case was appealed to the next level up to the Supreme Court. The decision was described as having the effect that the "Supreme Court ... has provided guidance for the first time in 60 years in the consolidated return context and clarified that an affiliated group should be treated as a single-entity taxpayer": D Lupi-Sher, "High Court Clarifies Consolidated Return Regulations" (2001) June 8 Tax Notes 1961.


98 Reg. 1.1502-12.
segregated tax attributes of each member (including separate taxable income, net capital gain and net operating loss) are combined together to arrive at the consolidated taxable income of the group, it appears that a "single entity" approach is followed.99

In summary, the U.S. consolidation regime adopts a "hybrid" approach between the single entity and separate entity approaches.100 On one hand, the separate entity doctrine seems to prevail as each group member is free to choose for example its own tax accounting methods of depreciation, trading stock, research and development expenditure.101 On the other hand, the enterprise doctrine has more influence on the treatments of group losses and intra-group asset transfers.102

4.4 Consolidation of group results
If a parent company owns less than 100 per cent of shares in a subsidiary, a policy question is whether the group’s consolidated taxable income or loss includes only the corresponding portion of the subsidiary’s taxable income or loss. The enterprise doctrine would suggest no. Under the doctrine, a group is treated as a single taxable unit provided that group members are under the common control of a parent company. It follows that once a subsidiary

99 This is evident from the tax case United Dominion Industries mentioned in note 96 above. In that case, the taxpayer was the parent of a consolidated group with 26 members. All of them incurred product liability expenses, but five of them had positive separate taxable income. The taxpayer followed the single entity approach to calculate its consolidated product liability loss. However, the IRS argued for a separate entity approach under which the product liability expenses of the five members could not contribute to the consolidated product liability loss. The Supreme Court ruled in favour of the taxpayer.


101 Hennessey, above note 7, paragraph 1.04[1].

102 For more detailed discussion of the treatment of group losses and intra-group asset transfers, see Chapter 6 Section 6.3 and Chapter 7 Section 7.3 respectively.
qualifies for consolidation, it should be treated as part of the single taxable unit and all its taxable income or loss should be included in the tax base of the taxable unit.

The policies of the eight countries on this issue are analysed in the following material.

**Australia**
As discussed in Section 4.3 above, under the strong SER, all subsidiaries are deemed to have disappeared under consolidation in Australia. It follows that the whole amounts of their taxable income and losses are deemed to be those of the parent company. The full consolidation policy is consistent with both the enterprise doctrine and the 100 per cent ownership threshold in its definition of a group. 103

**France**
Even if the parent company does not hold 100 per cent shares in the subsidiary, a subsidiary's results are fully consolidated in France. The policy is reasonable given the high ownership threshold of 95 per cent. 104 It also reflects a proper application of the enterprise doctrine.

**Italy**
One interesting feature of the consolidation regime in Italy is the relationship between its relative low ownership threshold of 50 per cent and the single entity concept. 105 Despite the low ownership threshold, the whole amount of

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103 Section 703-15(2) ITAA1997. The ownership requirements in the eight countries are discussed in detail in Chapter 5 “Definition of a Group”.
104 Article 223A CGI.
105 Articles 117 & 120 TUIR.
taxable income or loss of a subsidiary is consolidated. The presence of significant minority interest in the subsidiary does not prevent a full consolidation of tax results of a subsidiary.\textsuperscript{106}

\textbf{Japan}

Japan’s consolidation regime also adopts the full consolidation policy for subsidiaries’ taxable income and losses.\textsuperscript{107} The policy sits well with the 100 per cent ownership threshold in its definition of a group.\textsuperscript{108}

\textbf{The Netherlands}

The formation of a fiscal unity implies full consolidation of the subsidiary’s results, even if the parent company does not hold 100 per cent of the shares in the subsidiary.\textsuperscript{109} This is a reasonable application of the enterprise doctrine, as the ownership threshold for fiscal unity is close to 100 per cent, namely 95 per cent.\textsuperscript{110}

\textbf{New Zealand}

The tax law stipulates that all taxable income and losses of subsidiaries are aggregated to compute the group’s consolidated taxable income or loss.\textsuperscript{111}

\textsuperscript{106} In contrast, Italy’s worldwide consolidation regime, which is designed for consolidation of an Italian group including all non-resident subsidiaries, works on a pro-rata basis. Only the portion of a subsidiary’s taxable income or loss corresponding to the holding by the parent company is included in the consolidated tax computation: Article 131(1) TUIR.

\textsuperscript{107} Article 81 CTA.

\textsuperscript{108} Article 4-2 CTA.


\textsuperscript{110} Article 15(1) Vpb.

\textsuperscript{111} Section FM 3(1) ITA2007.
Spain
The full amount of a subsidiary’s taxable income or loss is included in consolidation, even if the parent company owns less than 100 per cent of shares in the subsidiary.\textsuperscript{112}

The United States
The consolidation regime in the U.S. also adopts full consolidation of taxable income and losses of subsidiaries, regardless of the level of shareholding in the consolidated subsidiaries.\textsuperscript{113}

4.5 Liability to tax
Under the enterprise doctrine, a corporate group is treated as one single taxable unit. It follows that the group should file one single tax return and all group members – being treated as one single entity – should be jointly liable to pay the group’s tax liability. In practice, for administrative convenience, most countries impose primary responsibility on the parent company to pay the group’s tax liability while at the same time ensuring that all group members are jointly and severally liable if the parent company defaults. Subtle differences in the detailed allocation rules of a group’s tax liability between group members reflect varying extents of application of the enterprise doctrine.

Australia
In Australia, as all subsidiary members are treated as “parts of the head

\textsuperscript{112} Section 71 LIS.
\textsuperscript{113} Reg.1.1502-11(a) & 1.1502-13.
company of the group" under the SER,\textsuperscript{114} the head company is deemed as the only taxpayer in the group. It follows that the head company has the primary responsibility for the tax liability of the group. However, practical administrative needs dictate an exception to the rule. The law stipulates that if the parent company defaults in tax payments, every subsidiary member of the group in general becomes “jointly and severally liable to pay the group liability”.\textsuperscript{115}

\textbf{France}

The parent company of a consolidated group is responsible for the group’s corporate tax liability.\textsuperscript{116} Each group member is jointly and severally liable for payment of the group tax to the extent of the tax liability of the company on a stand-alone basis.\textsuperscript{117}

The policy of limiting each group member’s liability to its “stand-alone” tax liability reflects a relatively strong influence of the separate entity doctrine. Compared with the alternative policy of joint and several liability to the group’s consolidated tax liability, this policy has the advantage of minimising uncertainty in the amount of hidden liability of a subsidiary in case of acquisition by a third party.

\textbf{Italy}

The rules on consolidated tax liabilities in Italy are similar to those in France.

\textsuperscript{114} Section 701-1(1) ITAA 1997.

\textsuperscript{115} Section 721-15(4) ITAA 1997. However, if covered by a valid tax sharing agreement, the law allows the liability of a subsidiary member to be limited to the amount determined under the agreement: section 721-30 ITAA 1997. Conditions for the tax sharing agreement are stipulated in section 721-25 ITAA 1997.

\textsuperscript{116} Article 223A CGI.

\textsuperscript{117} Article 223A CGI.
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The parent company of a consolidated group is responsible for the payment of the group’s consolidated income tax.\(^\text{118}\) A consolidated subsidiary and the parent company are jointly liable for the portion of the group’s consolidated tax liability that is attributable to the former’s taxable income. In addition, the parent company is jointly and severally liable with a subsidiary for penalties and interest imposed for the subsidiary’s own violations.\(^\text{119}\)

**Japan**

The parent company is primarily responsible for a group’s consolidated tax liability.\(^\text{120}\) At the same time, each subsidiary is jointly liable for the tax.\(^\text{121}\) A special feature of the Japanese regime is that the tax law stipulates the formula to allocate the consolidated tax liability among group members.\(^\text{122}\)

**The Netherlands**

Under the fiscal unity regime, the group’s tax liability is imposed on the parent company.\(^\text{123}\) However, all group members are jointly and severally liable for the tax.\(^\text{124}\)

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\(^{118}\) Article 118(3) TUIR. The author owes a debt to Guglielmo Maisto for his clarification of the rules on this issue.

\(^{119}\) Article 127(2) TUIR.

\(^{120}\) Articles 6-2, 81-26 & 81-27 CTA.

\(^{121}\) Article 81-28 CTA.

\(^{122}\) Article 81-18 CTA. Payments not conforming to the formula in general are deemed to be non-deductible expenses and taxable receipts: Masui, above note 27, at 45. The consolidation regime applies only to national corporate income tax, but not to local taxes. This policy is designed specifically to avoid potential issues of revenue allocation among municipal governments: ibid, at 46.

\(^{123}\) Article 15(1) Vpb.

The tax law was amended in 2003 making it clear that the group’s tax liability is levied on all group members as if they were a single taxpayer. Each subsidiary remains legally subject to Dutch corporate income tax, thus ensuring that it is entitled to treaty benefits.

New Zealand

In New Zealand, each group member is jointly and severally liable for income tax payable by the consolidated group. This is consistent with the underlying principle that the group is treated as a single company. Unlike other countries, no one particular group member has primary responsibility for the group’s consolidated tax liability. This reflects the unique feature of the New Zealand regime that a consolidated group may not include a parent company.

The joint and several liability is subject to two exceptions:

(1) The group may request that one or more specified group members be responsible for the group’s tax liability for an income year. The Commissioner must approve the application unless recovery of the income tax would be significantly prejudiced. The reason for this
exception is to facilitate consolidation of companies that “have financial arrangements subject to negative pledge clauses”.  

(2) The joint and several liability on a company that has left the group may be removed if, among other things, the assessment is made after the company left the group, and the Commissioner is satisfied that the removal of the liability will not significantly prejudice recovery of the tax liability.  

Spain

The parent company is responsible for payment of the group’s consolidated tax liability. However, every group member is jointly and severally for the tax. The joint liability does not cover penalties due to breach of group obligations. Such penalties are the sole responsibility of the parent company.  

The United States

The U.S. regime is one of the strictest among the eight countries in terms of rules on liability to tax. In general, all members of a group are “severally liable for the tax” on the consolidated return. The several liability can not be reduced by any “agreement entered into by one or more members of the

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132 Section FM 5 ITA 2007.
133 Section 82(1) LIS.
134 Section 66 LIS.
136 Reg. 1.1502-6(a).
group with any other member of such group or with any other person ... " 137

The only situation under which the several liability may be limited is when a company ceases to be a member of a group as a result of a bona fide sale of its stock for fair market value, such sale occurs before the assessment is issued, and the Commissioner believes that the collection of tax will not be jeopardised if the liability is so limited. Under these restrictive circumstances, the liability of the company may be limited to an amount “not exceeding the portion of such deficiency which the Commissioner may determine to be allocable to it”. 138

4.6 Election to consolidate

In theory, the enterprise doctrine should dictate that a corporate group under the control of a parent company be treated as a single taxable unit. However, in practice, consolidation regimes in all the eight countries are optional. Governments are willing to allow corporate groups to decide whether to be taxed as a single taxable unit or not. It reflects that the policy objective of competitiveness again trumps the enterprise doctrine on this issue.

There are subtle differences in the detailed rules of elections. For example, election to consolidate in some countries is irrevocable, or for a fixed term. The following material analyses the rules in the eight countries. 

137 Reg. 1.1502-6(c). In practice, though not valid against the Internal Revenue Service, loss members are often compensated by profit members for the use of their losses: Sparagna, above note 54, at 717. The allocation of group tax liability among group members does not have significant tax implications, except its effect on earnings and profits of a group member which may affect the annual basis adjustment rules for its shares – see discussion of the rules in Chapter 8 “Treatment of Intra-group Shareholdings”. Though the group can choose any allocation method after obtaining consent from the tax authorities, many use one of the methods prescribed in IRC section 1552 or Reg.1.1502-33(d): Hennessey, above note 7, paragraph 16.11[2].

138 Reg. 1.1502-6(b).
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Australia

The tax law in Australia stipulates that its consolidation regime is optional. However, in practice most corporate groups are effectively forced to consolidate as they are denied access to the previous group taxation regimes since the introduction of consolidation. It is observed that “it will only be in extremely limited circumstances that a corporate group will ultimately determine not to consolidate” (emphasis added). The de facto “mandatory” regime is consistent with the emphasis of the “anti-avoidance” objective in the consolidation regime.

In general, a choice to consolidate is irrevocable. The choice is effective until the group ceases to exist. A consolidated group ceases to exist only if either the head company ceases to qualify as a head company, or becomes a member of a MEC group.

The strict irrevocability rule is not applied consistently to MEC groups. If the nominated head company of a MEC group leaves the group and the group does not nominate another tier-1 company to be the new head company within

139 Section 703-50 ITAA1997.
141 Ibid.
142 Section 703-50(2) ITAA 1997. However, in practice, it is not difficult for a subsidiary member to leave a consolidated group. A minimal reduction in the 100% shareholding by a head company in the subsidiary member would be sufficient to achieve this. See discussion in Chapter 5 Section 5.5.
143 Section 703-50(4) ITAA 1997.
144 Section 703-5(2) ITAA 1997.
28 days, the MEC group ceases to exist.\textsuperscript{145} This effectively allows a MEC group to revoke its election to consolidate.\textsuperscript{146}

\textbf{France}

The election to consolidation is irrevocable for a 5-year term.\textsuperscript{147} The fixed term is designed to be an anti-avoidance measure to discourage “frequent entries and departures of various companies into and from the consolidated group”.\textsuperscript{148}

An indefinite term – which is the policy adopted in some countries – would be more effective as an anti-avoidance measure to tackle the abuse of “frequent entries and departures”. The relatively short “5-year term” suggests a compromise with the other policy objective of competitiveness.

\textbf{Italy}

The election to consolidation is irrevocable for a 3-year term.\textsuperscript{149} Compared with other countries’ policy of irrevocable election for an indefinite term, the rule in Italy reflects a dominant policy objective of competitiveness over anti-avoidance concerns.

\textbf{Japan}

A corporate group can elect to consolidate in Japan, which is subject to the

\textsuperscript{145} Section 719-60 & 719-80 ITAA1997.
\textsuperscript{146} Lehmann, above note 6, at 274.
\textsuperscript{147} Article 223A CGI.
\textsuperscript{148} Knoepfler & Anderson, above note 17, at 173.
\textsuperscript{149} Article 117(3) TUIR.
approval of the tax authorities. The election must be made at least 6 months before the year intended to commence consolidation.

The election is in general irrevocable. A consolidated member may apply to terminate consolidation under certain “unavoidable” circumstances, but this is subject to the approval of the tax authorities.

Japan has an anti-avoidance provision preventing a company from re-consolidating with the same consolidated group within 5 years after leaving the group.

The Netherlands
A parent and a subsidiary may jointly request to consolidate. It is subject to the approval of the tax authorities. The election is for an indefinite term but revocable. The consolidation of a parent and a subsidiary can terminate by a joint request submitted to the tax authorities. The termination will not affect fiscal unity between the parent company and other group members.

The flexibility of revocable election reflects a strong influence of the policy

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150 Articles 4-2 & 4-3(1) CTA. The tax law lists situations under which the tax authorities may refuse the election: Article 4-3(2) CTA. For example, an election to consolidate may be refused if consolidation would result in inappropriate reduction of corporate tax liabilities: Article 4-3(2)(d) CTA.

151 Article 4-3(1) CTA.

152 Article 4-5(3) CTA.


154 Article 15(1) Vpb.

155 Article 15(8) Vpb.

156 Article 15(6) Vpb. An anti-avoidance provision prevents a subsidiary from joining and leaving a consolidated group in the same year: Article 15(7) Vpb.

157 Article 15(6)(d) Vpb.
Chapter 4 Policy Objectives and Five Key Structural Elements

objective of competitiveness, which prevails over the enterprise doctrine and the anti-avoidance concerns.

**New Zealand**
The rules of election to consolidate are very flexible in New Zealand. They allow not only a group to elect to consolidate, but also a group member to elect to leave a consolidated group.\(^{158}\) Therefore it is unnecessary for the law to stipulate whether the choice to consolidate is revocable or not. The rules reflect a dominant policy objective of competitiveness.

**Spain**
The election to consolidate is for indefinite term,\(^{159}\) but can be terminated by withdrawing the election.\(^{160}\) It is possible to have consolidation for only one tax year.\(^{161}\)

Before 2002, the election was irrevocable for a 3-year term.\(^{162}\) The policy change suggests an increasing emphasis on the policy objective of competitiveness.\(^{163}\) The ability to revoke the election creates tax planning opportunities.\(^{164}\)

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\(^{158}\) Section FM 37 ITA 2007. In general the cessation will be effective from either the beginning of the income year in which the company makes the election, or the beginning of the following income year: section FM 39 ITA 2007.

\(^{159}\) Section 64 & 70(5) LIS.

\(^{160}\) Section 70(5) LIS.

\(^{161}\) Stepholt, above note 135, at 406.


\(^{163}\) Consistent with this objective, the ownership threshold for consolidation was relaxed from 90% to 75% in the same year: Stepholt, above note 135, at 403.

\(^{164}\) Ruiz, above note 45, at 616.
The United States
The consolidation regime in the U.S. is optional. However, it has not always been so. The regime was not optional when it was first introduced in 1917. With an anti-avoidance objective, consolidation was then imposed by the Commissioner. The regime became elective in 1922 when the tax law was changed making the anti-avoidance objective irrelevant.

An election to consolidate is irrevocable. A consolidated group has to continue to file consolidated return unless it obtains approval to cease consolidation. The approval may be obtained in two ways:

1. The parent company applies to discontinue filing consolidated returns for “good cause”, and the Commissioner approves. For instance, the Commissioner may approve an application if “the net result of all amendments to the Code or regulations ... has a substantial adverse effect on the consolidated tax liability of the group ... relative to what the aggregate tax liability would be if the members of the group filed separate returns ...”.

2. The Commissioner may grant a blanket permission to all groups to cease consolidation if he believes that any amendment to the Code or regulations has a substantial adverse effect to the group relative to separate filings by the members.

\(^{165}\) Section 1501 IRC.

\(^{166}\) Hennessey, above note 7, paragraph 1.02[2]. See discussion in Section 4.2 above for more analysis of the policy objective of the regime.

\(^{167}\) Reg. 1.1502-75(a)(2).

\(^{168}\) Reg. 1.1502-75(c)(1).

\(^{169}\) Reg. 1.1502-75(c)(2). For an example of such blanket permission, see Rev. Proc. 91-11.
An anti-avoidance provision in general prevents a subsidiary from rejoining a consolidated group for 5 years.\textsuperscript{170}

### 4.7 The “all in” rule

Under the enterprise doctrine, a corporate group under the common control of a parent company should be treated as one single taxable unit. It implies that all group members should be included in a consolidated group. In practice, the application of the doctrine may be restricted by other policy objectives that the governments consider important. For instance, the policy objective of competitiveness may trump the enterprise doctrine. A government may decide to improve competitiveness of corporate groups by allowing “cherry-picking” of subsidiaries to consolidate, though the policy deviates from the enterprise doctrine.

The following paragraphs analyse how the eight countries deal with the “all in” rule issue.

**Australia**

Australia fails to have a consistent policy on the “all in” rule. It adopts the rule for domestically owned groups, but allows cherry-picking of subgroups for foreign-owned groups.

For domestically owned groups, a consolidated group must include the top parent company (known as the “head company”) and \textit{all} its subsidiary

\textsuperscript{170} Section 1504(a)(3) IRC. The provision prevents a consolidated group from transferring a profitable subsidiary to a loss group and then reacquiring the subsidiary within 5 years: Hennessey, above note 7, paragraph 3.04.
members.\textsuperscript{171} The regime further requires that the head company must be the top holding company of the group that is qualified to be a head company.\textsuperscript{172} The government argues that departure from the all in rule “would add considerable complexity to the consolidation regime and could compromise the integrity of the regime by allowing unintended tax benefits to be obtained from transactions between member and non-member entities”.\textsuperscript{173} Nevertheless, as discussed above, the anti-avoidance objective is undermined by the strict ownership requirements. It is possible to circumvent the “all in” rule by becoming a say “99%” subsidiary, or by inserting an intermediate non-resident holding company.\textsuperscript{174}

Under the enterprise doctrine, if a foreign parent company controls a number of Australian corporate chains, the Australian subgroups should be allowed to consolidate as they are under the common control of a parent company. At the same time, the “all in” rule should be enforced. This is not only a proper application of the enterprise doctrine, but also provides neutral treatment to both foreign and domestic groups while maintaining a consistent anti-avoidance focus.

\textsuperscript{171} This policy is achieved quite indirectly by the combination of several provisions. Section 703-10 ITAA 1997 defines a “consolidatable group” as consisting of the head company and all the subsidiary members of the group. Section 703-5(1)(a) in turn defines a “consolidated group” as coming into existence upon the election by the head company to consolidate the “consolidatable group”. New subsidiary members acquired by an existing consolidated group must also be included in the consolidation pursuant to section 703-5(3).

\textsuperscript{172} In particular, the head company must not be a wholly owned subsidiary of another company qualified to be a head company: section 703-15 ITAA 1997.

\textsuperscript{173} EM to May 2002 Consolidation Act, paragraph 3.5. It is not surprising that tax practitioners had argued against the “all in” rule during consultation: Lehmann, above note 6, at 267.

\textsuperscript{174} For detail of the membership requirements, see Chapter 5 “Definition of a Group”. Restructure of a group would have to be carefully planned and executed; otherwise the general anti-avoidance provision in Part IVA of ITAA1936 may apply to negate the intended effect.
However, the “all in” rule does not apply consistently to foreign-owned groups. For instance, a foreign-owned group may have three subgroups of wholly owned entities in Australia. The government allows each subgroup to choose either to form a multiple entry consolidated groups (“MEC group”) with the other subgroups, or simply to form a normal consolidated group on its own.\(^{175}\)

The policy effectively allows “cherry-picking” of subgroups, and is illustrated in Diagram 8 below:

**Diagram 8 Cherry-picking of subgroups in Australia**

175 Sections 703-5 & 719-5 ITAA 1997. Such flexibility is confirmed in EM May 2002 Consolidation Act, paragraph 4.3.
Each tier-1 company – that is, the first level of wholly-owned resident subsidiaries in Australia – can individually choose to stay out of consolidation or not. Possibilities include:

1. all six resident companies (A to F) form a MEC group;
2. any two out of A, B and C subgroups form a MEC group; and
3. any one of A, B and C forms a normal consolidated group with its subsidiary, or can choose to remain as a separate taxpayer.

The government justifies the flexible policy by arguing that it is designed to “meet the operational needs of certain foreign-owned groups which operate their subsidiaries on an autonomous basis”.176 The accommodating attitude for taxpayers is to be appreciated, but it begs the question why similar latitude is not extended consistently to domestic groups. It creates serious doubt on whether the tax avoidance concern that underlies the “all in” rule for domestically owned groups is really justified. If the exposure to such abuse is significant for domestic groups, one can hardly argue that the concern is irrelevant for foreign-owned groups. Conversely, if such exposure is remote, the “all in” rule for domestic groups would be unnecessarily strict.

The generous policy for MEC groups appears to be a response to lobbying by foreign multinationals and their advisors.177 The response of the government

176 EM May 2002 Consolidation Act, paragraph 4.4.
177 Basically, they argued that many Australian subgroups of foreign multinationals “do not communicate closely with [each other] ... Their managements may report through separate chains of entities in the foreign multinational” and it is not reasonable to “expect foreign-owned multinationals to structure their [Australian operations] to fit in with Australia’s consolidation regime as it applies to Australian-owned groups”: Lehmann, above note 6, at 274. The arguments of foreign multinationals are debatable. Even if their Australian subgroups do not communicate with each other in practice, the foreign parent company – which presumably has control over all its wholly-owned subgroups anywhere in the world – should have sufficient influence over the subgroups to ensure compliance with a single
not only surprises tax commentators, but also the lobby groups, especially when those rules were decided only after “a consultation period of about a couple of months”.  

**France**

The tax law does not require all eligible subsidiaries to be included in a consolidated group. The parent company is free to “cherry-pick” subsidiaries to consolidate.

This flexible policy is consistent with the relatively weak application of the enterprise doctrine in France’s consolidation regime, under which each subsidiary maintains to a large extent a separate identity during consolidation. It also allows a group to “control the effective rate of its taxation by choosing the companies which will be consolidated ....”

**Italy**

The consolidation regime in Italy allows “cherry-picking” of subsidiaries to join consolidation. It is more flexible than the French counterpart in two aspects: (1) the parent company of a consolidated group can be a company other than the top parent company in Italy; and (2) the ownership threshold is consolidated group under the “all in” rule. Furthermore, if the benefits of consolidation are sufficiently significant, it is doubtful if the parent company would not insist on its subgroups forming a consolidated group. Group restructures are not uncommon for multinationals to achieve the best tax outcome. The policy allowing “cherry-picking” of subgroups for MEC groups thus seems surprisingly liberal.

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178 Ibid.

179 Mentec, above note 13, at 3. This flexible policy has been in place since the consolidation regime was introduced in 1988: Knoepfler & Anderson, above note 17, at 172.

180 Knoepfler & Anderson, ibid, at 175.

the lowest among the eight countries, namely a simple majority of more than 50 per cent.\textsuperscript{182}

For example, consider the following group in Diagram 9 below:\textsuperscript{183}

\textbf{Diagram 9 Cherry-picking of subsidiaries in Italy}

\begin{center}
\begin{tikzpicture}
  \node[rectangle,draw] (A) {Company A};
  \node[rectangle,draw,below of=A] (B) {Company B} edge[->] (A)
    node[midway,above] {80\%};
  \node[rectangle,draw,below of=B] (C) {Company C} edge[->] (B)
    node[midway,above] {70\%};
\end{tikzpicture}
\end{center}

In total, four alternative consolidated groups may be formed out of this structure, namely:

(1) A with B and C;

(2) A with B only;

\textsuperscript{182} See Chapter 5 Sections 5.2 and 5.5 for more detailed discussion of the two issues respectively.

\textsuperscript{183} This example is based on Examples 2, 3 & 4 in Leone & Zanotti, above note 23, at 189.
(3) A with C only; and
(4) B with C.

The flexible policy is consistent with the policy objective of competitiveness of the Italian consolidation regime. However, it is prone to abuse.

**Japan**
The consolidation regime in Japan adopts the “all in” rule, reflecting an application of the enterprise doctrine.

**The Netherlands**
The fiscal unity regime in the Netherlands does not adopt the “all in” rule. In fact, the basic building block of a consolidated group is defined to be between two companies: a parent company and a subsidiary.

The regime is very flexible in terms of choice of group members to consolidate. It allows not only “cherry-picking” of subsidiaries, but also forming a consolidated group without the top resident parent company. The flexible policy suggests an emphasis of the policy objective of competitiveness.

**New Zealand**
New Zealand has one of the most flexible policies among the eight countries. There is no “all in” rule in New Zealand. In fact, any two or more eligible

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184 In contrast, the Italian government is more prudent with their worldwide consolidation regime: the “all in” rule do apply to non-resident subsidiaries of the parent company: Article 132(2)(a) TUIR.
185 Giaconia, above note 19, at 383.
186 Article 4-2 CTA. See also Komamiya, above note 26, at 395.
187 Article 15 Vpb.
companies of a wholly-owned group may elect to form a consolidated group. 188 A parent company is not necessary. It means that brother-sister companies can form a consolidated group. This policy is unique among the eight countries. Any other eligible group company may elect to join an existing consolidated group. 189 Furthermore, a member of a consolidated group is free to elect to exit the group. 190

The flexible “cherry-picking” policy deviates from the enterprise doctrine. The taxpayer-friendly regime is protected by a number of anti-avoidance provisions, targeting arrangements designed to “defeat the intent and application of consolidation rules”. 191

Spain
In contrast to its European counterparts, Spain imposes the “all in” rule in its consolidation regime. 192 All eligible subsidiaries of a parent company must be included in its consolidated group, including newly acquired subsidiaries. 193 This reflects a stronger application of the enterprise doctrine than the other European countries.

The United States
The U.S. requires all eligible companies of an affiliated group to be included

188 Section FM 35(1) ITA 2007.
189 Section FM 36 ITA 2007.
190 Section FM 37(a) 2007.
191 For example, sections FM 31(6), FM 38(7) & FM 40(5) ITA 2007.
192 Article 67(1) LIS.
193 Ruiz, above note 45, at 616; and Stepholt, above note 135, at 405.
in the consolidated returns. However, the "all in" rule is softened by allowing a lower level holding company – instead of the top parent company resident in the U.S. – to be the head company of a consolidated group (known as the "common parent company"). In particular, there is no requirement on the ownership of the interests in the common parent company.

4.8 Conclusion

The policy objectives of the eight countries, arranged chronologically according to the years of introduction of their consolidation regimes, are summarised in Table 2 below:

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194 Reg. 1.1502-75(a)&(e). In particular, in general all eligible members must file consents (Form 1122) to the consolidation regulations before they can file a consolidated return: Reg. 1.1502-75(a)(1).

195 An "affiliated group" is defined as "1 or more chains of includible corporations ... with a common parent corporation ..., but only if ... the common parent owns directly stock meeting the requirements [i.e. the "80% ownership" test] ... in at least 1 of the other includible corporations ...": IRC section 1504(a)(1). There is no similar requirement as in Australia which requires that the head company must not be held by another company eligible to be a head company: section 703-15(2) item 1 column 4 ITAA 1997.
### Table 2 Policy Objectives of Consolidation

<table>
<thead>
<tr>
<th>Country</th>
<th>Year of Introduction</th>
<th>Enterprise Doctrine</th>
<th>Competitiveness</th>
<th>Anti-avoidance</th>
</tr>
</thead>
<tbody>
<tr>
<td>US</td>
<td>1917</td>
<td>✓ / x (now)</td>
<td></td>
<td>✓ (original)</td>
</tr>
<tr>
<td>Netherlands</td>
<td>1940</td>
<td>✓</td>
<td></td>
<td></td>
</tr>
<tr>
<td>France</td>
<td>1971</td>
<td>✓</td>
<td>✓</td>
<td></td>
</tr>
<tr>
<td>Spain</td>
<td>1977</td>
<td></td>
<td>✓</td>
<td></td>
</tr>
<tr>
<td>New Zealand</td>
<td>1992</td>
<td>✓</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Australia</td>
<td>2002</td>
<td>✓</td>
<td></td>
<td>✓</td>
</tr>
<tr>
<td>Japan</td>
<td>2002</td>
<td></td>
<td>✓</td>
<td></td>
</tr>
<tr>
<td>Italy</td>
<td>2004</td>
<td></td>
<td>✓</td>
<td></td>
</tr>
<tr>
<td>South Korea*</td>
<td>2010</td>
<td>✓</td>
<td>✓</td>
<td></td>
</tr>
</tbody>
</table>

* South Korea is included in this table for reference only. Its consolidation regime is not studied in detail in this thesis.

All the eight countries introduced consolidation with a policy objective of either applying the enterprise doctrine or competitiveness. As discussed in Chapter 2, the application of the enterprise doctrine is consistent with and promotes the policy objective of competitiveness. Under the doctrine, a corporate group is treated as a single taxable unit in a consolidation regime, allowing both intra-group loss offset and tax free intra-group asset transfers. These tax implications would reduce tax burden of corporate groups and facilitate group reorganisations, thus achieving the policy objective of
competitiveness.

The logic does not always work in reverse. Adopting competitiveness as a policy objective does not necessarily imply the application of the enterprise doctrine. Italy is an obvious example. Despite its competitiveness objective, its consolidation regime demonstrates a strong influence of the separate entity doctrine.

The comparative analysis reveals that the policy objective of competitiveness – either as an explicit policy objective or indirectly through the policy objective of applying the enterprise doctrine – has been the predominant rationale for the introduction of consolidation regimes in the eight countries.

Australia stands out with anti-avoidance as one of the policy objectives of its consolidation regime. The fact that the regime is very popular among corporate groups suggests that the anti-avoidance objective may not have been achieved effectively. Its other policy objective of simplicity is also unusual among the eight countries. Contrary to the objective, it is one of the most complicated regimes in the tax law.

The extents of application of the enterprise doctrine in the eight countries with respect to the five key structural elements analysed in this chapter are summarised in Table 3 below:

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196 The U.S. regime dropped its original anti-avoidance objective in 1921 as soon as the progressive tax rate system – which was then subject to abuse by corporate groups – was abolished.
### Table 3 Application of the enterprise doctrine in five key structural elements

<table>
<thead>
<tr>
<th>Country</th>
<th>Australia</th>
<th>France</th>
<th>Italy</th>
<th>Japan</th>
<th>Netherlands</th>
<th>NZ</th>
<th>Spain</th>
<th>US</th>
</tr>
</thead>
<tbody>
<tr>
<td>Single entity concept</td>
<td>Absorption</td>
<td>Pooling</td>
<td>Pooling</td>
<td>Pooling</td>
<td>Attribution</td>
<td>Pooling</td>
<td>Pooling</td>
<td>Pooling</td>
</tr>
<tr>
<td>Full consolidation of group results</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>Joint liability for group's tax liability</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>Election to consolidate: revocable?</td>
<td>X (except MEC groups)</td>
<td>X (5-year term)</td>
<td>X (3-year term)</td>
<td>X (Note)</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>X (Note)</td>
</tr>
<tr>
<td>“All in” rule</td>
<td>✓ (except MEC groups)</td>
<td>X</td>
<td>X</td>
<td>✓</td>
<td>X</td>
<td>X</td>
<td>✓</td>
<td>✓</td>
</tr>
</tbody>
</table>

Note: Subject to limited exceptions.
All the eight countries have full consolidation of group members’ taxable income and losses, instead of proportional consolidation. This reflects a consistent application of the enterprise doctrine. Joint and several liability to the group’s consolidated tax is the next most consistent policy among the eight countries. All countries, except France and Italy, impose joint and several liability on group members. This policy is not only consistent with the enterprise doctrine, but also serves well the fundamental objective of a tax system: revenue collection. The two exceptions – France and Italy – reflect a relatively strong influence of the separate entity doctrine in their consolidation regimes.

The eight countries exhibit similar consistency in the application of the single entity concept in their consolidation regimes. All the eight countries, except Australia and the Netherlands, adopt the pooling system. However, detailed analysis of the six consolidation regimes reveals subtle differences in the pooling system, suggesting different extents of application of the enterprise doctrine. In France, Italy, Japan and Spain, group members remain to a large extent as separate entities, and still have to prepare and submit individual tax returns during consolidation. While consolidated group members do not have to prepare and submit separate tax returns, the U.S. regime fails to demonstrate a consistent application of the enterprise doctrine. It is basically a hybrid between the single entity and separate entity approaches. In contrast, the consolidation regime in New Zealand demonstrates less influence of the separate entity doctrine. Group members do not have to file separate tax returns once they elect to consolidate. Taxability and deductibility of each company’s income and expenses is determined on a group basis.

The Netherlands adopts the attribution model under which assets and activities of subsidiaries are deemed to be those of the parent company. This reflects a
stronger application of the enterprise doctrine than the pooling system. The single entity concept in Australia represents the strongest application of the doctrine among the eight countries. Under its SER, not only assets and activities of subsidiaries are attributed to the parent company, subsidiaries are also deemed to have “disappeared” for income tax purposes. The strong SER has proved to be complicated and problematic. The divergent policies on the single entity concept demonstrates that the application of the enterprise doctrine in practice is a difficult balancing act, often involving trade-offs and compromises between competing objectives and constraints.

The eight countries are less consistent in their policies on the other two key structural elements. They are divided with respect to the “all in” rule. Four countries – namely France, Italy, the Netherlands and New Zealand – allow “cherry-picking” of subsidiaries. Three countries – Japan, Spain and the U.S. – impose the “all in” rule. Australia fails to have a consistent policy. It imposes the “all in” rule for domestically-owned groups, but allows cherry-picking of subgroups for foreign-owned groups. It is difficult to determine which approach is better. The diverse policy choices with respect to the “all in” rule among the eight countries reflect the difficult compromises governments have to make between competing policy objectives. On one hand, the “all in” rule serves an anti-avoidance objective by insisting all eligible group companies be consolidated. On the other hand, allowing cherry-picking promotes the policy objective of competitiveness.

The eight countries are also divided on the issue of whether the election to consolidate is revocable or not. Three countries – namely the Netherlands, New Zealand and Spain – allow a group to revoke the election. Four countries – namely France, Italy, Japan and the U.S. – in general do not allow a group to revoke the election. However, the relatively short terms of an election in
France (5 years) and Italy (3 years) represent a less rigorous anti-avoidance policy than in the other two countries. Australia again does not have a consistent policy on this issue. An election to consolidate is irrevocable for domestically-owned groups, but is effectively revocable for foreign-owned groups.

The divergent policies with respect to the revocability of election to consolidate again demonstrate the difficult compromise that policy makers have to make between competing policy objectives. The policy choice between a revocable and irrevocable election represents a trade-off between the enterprise doctrine and anti-avoidance concerns – which would suggest an irrevocable election – and the policy objective of competitiveness which would suggest a revocable election.

The above analysis shows that the consolidation regimes in the eight countries represent a spectrum of different extents of application of the enterprise doctrine, ranging from the strong SER in Australia to the relatively weak single entity concept in Italy. In between the two extremes lie the other consolidation regimes with varying extents of applications of the enterprise doctrine.

The other five key structural elements of a consolidation regime – namely, definition of a group, treatment of pre-consolidation losses, group losses, assets and intra-group shareholdings – are analysed and compared in detail in the next four chapters. Together with this chapter, they pave the way for the overall comparative analysis of the eight consolidation regimes in Chapter 10.

The key structural element of “definition of a group” is analysed in the next chapter.
CHAPTER 5
DEFINITION OF A GROUP

5.1 Introduction

This chapter analyses and compares the definitions of a group under the consolidation regimes in the eight countries. The definition of a group is a key structural element of a consolidation regime. As discussed in Chapters 2 and 3, the definition of a taxable unit is one of the key dimensions of application of the enterprise doctrine to the taxation of corporate groups.

The definition of a group comprises of two key elements:

(1) entities eligible to join consolidation; and
(2) the ownership requirements.

On the first key element of the definition of a group, a consolidation regime has to determine whether the following entities should be eligible to join consolidation:

(1) a non-resident company;

\[\text{For an earlier comparison of the membership requirements of consolidation regimes in Australia, New Zealand and the U.S., see Antony Ting, "Policy and Membership Requirements for Consolidation: A Comparison between Australia, New Zealand and the US" (2005) 3 British Tax Review 311. The analysis of the issues for these three countries is substantially updated and expanded in this chapter.}\]
Chapter 5 Definition of a Group

(2) a permanent establishment of a non-resident company; and

(3) a resident company held through an interposed non-group member (for example, a non-resident company).

As discussed in Chapter 2, under the enterprise doctrine, a corporate group under the common control of a parent company should be treated as one single taxable unit. One of the critical constraints on its application in practice is the differential spans between the economic substance — that a corporate group operates as a single enterprise — and the political jurisdiction. In practice, most group taxation regimes are confined to groups of resident companies in a country. Exceptions are rare. The main reasons for the exclusion of non-resident companies are revenue concerns and administrative costs. The inclusion of non-resident companies in a group taxation regime has also proved to be prone to abuse.

Some countries, especially the EU member states, expand the scope of consolidation to cover permanent establishments of non-resident companies. This phenomenon is driven not by the application of the enterprise doctrine, but by the EU non-discrimination rules especially certain ECJ decisions on those rules. The inclusion of PEs but exclusion of non-resident head offices as

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2 For example, France and Italy have worldwide group pooling regimes, but they have very limited use in practice. See Chapter 3 Section 3.3 for more detail.


4 For example, the joint taxation regime in Denmark (which allows loss offset between resident and non-resident group members), together with its flexible cherry-picking policy, has been described as “collecting” losses from around the world: Report on “Tax Policy Reforms in Denmark” in OECD, Tax Policy Development in Denmark, Italy, the Slovak Republic and Turkey (available at www.oecd.org), accessed on 24 November 2007, at 12.

5 For a brief survey of the EU countries that allow PEs in their grouping regimes, see Marco Adda, “Can A Permanent Establishment Be a ‘Legitimate Heir’ in a Domestic Consolidated Tax Regime?” (2008) 48(9) European Taxation 238, at 239-240. See also Masui, above note 3, at 53-55 & 58-62.
group members poses interesting issues. For example, if a PE acts as the head entity of a consolidated group and a subsidiary in the group pays interest expenses to the PE’s non-resident head office, the issue is whether the interest expense should be deductible to the consolidated group.

The other key element of the definition of a group is the ownership requirements, which consist of two critical factors:

1. the ownership threshold: should the threshold represent “perfect control” (that is, 100%), or just a bare majority (that is, more than 50%), or some level in between?

2. the factors of “control”: what should be the factors of “control” in the definition of a group? Should it be shareholding, voting rights, value of shares, or a combination of these factors?

These issues of the definition of a group and the alternative policy options adopted in the consolidation regimes in the eight countries are analysed and compared in the following material. A summary of the findings and an overall evaluation are provided in Section 5.7.

5.2 Eligible entities
Another issue is what types of entities should be allowed to join consolidation. It raises the question of whether a consolidation regime should be restricted only to resident companies in a country, or cover non-resident companies, or their permanent establishments in the country. This section analyses the alternative policies on these issues. For the purpose of clarity and to facilitate comparison, the analysis discusses the policies on parent company and
subsidaries separately. The issues of excluded entities and interposed non-member entities are discussed in the next two sections.

**Australia**

(a) Parent company:

In Australia, a consolidated group in general must have a single head company. This requirement is important in the context of the Australian regime, as all subsidiaries are deemed to become parts of the head company under its strong single entity rule. In other words, the status of the head company dictates the tax treatment of the consolidated group.

A head company in general must be a resident company in Australia, and not regarded as a non-resident under tax treaty. It must be the top holding company in Australia. This requirement is consistent with the “all in” rule which ensures that all Australian resident group members are included in the consolidated group.

An important exception to the “top” resident parent company requirement is for foreign-owned groups that have multiple subgroups in Australia. They are subject to a special regime known as the “multiple entry consolidated”}

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6 Section 703-5(2)&(3) ITAA 1997. An exception is the MEC group regime which is discussed below.
7 For discussion of the single entity concept in Australia, see Chapter 4 Section 4.3.
8 Section 703-15(2) item 1 ITAA 1997. Similar requirement applies to the head company of a MEC group pursuant to the combined effect of s.719-15, 719-20, 719-25 & 719-75 ITAA 1997. “Company” is defined as “a body corporate; or … any other unincorporated association or body of persons; but does not include a partnership or a non-entity joint venture”: section 995-1 ITAA1997. “Corporate limited partnership”, defined basically as a limited partnership, is in general deemed to be a “company” and not a “partnership” for tax purposes: sections 94D, 94J &94K ITAA 1936. Therefore, it can be a head company of a consolidated group: this position is confirmed in EM to May 2002 Consolidation Act, paragraph 3.30. An exception to the rule is that certain corporate unit trusts and public unit trusts may elect to be a head company, provided they are taxed as companies: Subdivision 713-C ITAA1997.
9 Section 703-15(2) item 1 column 4.


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("MEC") group rules.\(^\text{10}\) To be eligible for the more flexible MEC group rules, the foreign parent company must not be a resident of Australia under the domestic income tax law.\(^\text{11}\) The group has to elect one of the "tier-1 companies" in Australia to be the "head company" of the MEC group.\(^\text{12}\) "Tier-1 companies" basically means the first level of wholly-owned resident subsidiaries of the foreign parent company.\(^\text{13}\)

A typical structure for a foreign-owned group eligible for the MEC group regime is depicted in Diagram 10 below:

Diagram 10 MEC groups in Australia

\(^{10}\) Division 719 ITAA1997.

\(^{11}\) Section 719-20(1) item 1 ITAA1997.

\(^{12}\) Section 719-75 ITAA1997.

\(^{13}\) Section 719-20(1) item 2 ITAA1997.
As discussed in Chapter 4 Section 4.7, the MEC group rules allow cherry-picking subgroups in Australia. In general, each of the resident subgroups is free to decide whether or not to join together and form a MEC group. For instance, Company A can form a MEC group with Companies B and C, while leaving the other companies unconsolidated. In that case, the MEC group has to elect either A or B as the “head company” of the group. In contrast with the normal consolidation regime for domestic groups, the head company of a MEC group is not the top resident holding company for all members in the consolidated group.

One advantage of the MEC group regime is that it allows subgroups to form one single consolidated group in Australia. This is not possible in all of the other seven countries except New Zealand. For instance, the U.S. allows each domestic subgroup owned by a foreign parent company to form a separate consolidated group, but not as one single consolidated group. A foreign-owned group may have multiple consolidated groups in one country, and can not enjoy the full benefits of consolidation such as loss offset among the subgroups. This contradicts the enterprise doctrine, as all subgroups are under the common control of the foreign parent company.

In contrast to the strict “all in” rule imposed on domestically-owned groups, the MEC group rules allow “cherry-picking” of subgroups. This policy represents a bias towards foreign multinational groups. Allowing cherry-

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14 New Zealand is unique in this respect as it allows brother-sister companies of a wholly-owned group to consolidate, regardless of whether the top parent company is a resident or not. This model provides a neutral treatment to both domestic and foreign-owned groups, allowing multiple subgroups to consolidate in the country. See discussion of the rules in New Zealand below.


16 For more discussion of the flexible rules for MEC groups, see Chapter 4 Section 4.7.
picking subgroups also creates tax planning potential.\textsuperscript{17} The policy contradicts the anti-avoidance objective of the Australian consolidation regime.

(b) Subsidiaries:
All subsidiary members must be resident of Australia under both domestic law and tax treaty.\textsuperscript{18}

In contrast to the requirement that the head company in general must be a company, other members of a consolidated group can be a company, trust or partnership.\textsuperscript{19} Allowing partnerships and trusts as subsidiary members in a consolidated group is a unique feature among the consolidation regimes in the eight countries.\textsuperscript{20}

\textit{France}

(a) Parent company:
In general, only companies subject to normal French corporate income tax can be a member of a consolidated group.\textsuperscript{21} This means that foreign entities and

\textsuperscript{17} For example, it is observed in the U.S. that allowing resident subgroups of a foreign parent company to form separate consolidated groups is prone to abuse: Hennessy, above note 15, paragraph 2.04.

\textsuperscript{18} Section 703-15(2) item 2 column 3.

\textsuperscript{19} Section 703-15(2) item 2 ITAA 1997. For MEC groups, see Section 719-10(1)(b) ITAA 1997.

\textsuperscript{20} Detailed analysis of this issue is outside the scope of this thesis. For more discussion of the issue, see Ting, above note 1, at 324-325.

\textsuperscript{21} Article 223A CGI. The French corporate income tax is levied on a territorial basis: profits or losses attributable to foreign permanent establishments are in general excluded from the tax. It follows that the French domestic consolidation regime also operates under the territorial basis: Frank Le Mentec, “French Tax Group Regimes” in \textit{The European Union and Group Relief: How will the Marks & Spencer Case Impact? (Special Report)} (2006, BNAI, Washington), at 2. The tax law has a special regime under which a French company may apply to include the profits and losses of all its foreign PEs for corporate income tax purposes: Article 209 CGI. However, the regime has never been used in practice due to its stringent requirements and the condition that all PEs have to be included: IBFD, “Country Analyses - France - Corporate Taxation (online database)” (available at www.ibfd.org), accessed on 28
French non-corporate entities (for example, partnerships) in general are not eligible to consolidate.\textsuperscript{22}

Since 2005, a PE of a foreign company can also be the head of a consolidated group, provided that the PE is subject to French corporate income tax and the shareholdings in its French subsidiaries are recorded as PE assets.\textsuperscript{23}

The parent company of a consolidated group in general must be the top holding company in France, as not more than 95 per cent of its shares can be held directly or indirectly by another entity subject to French corporate tax.\textsuperscript{24} However, this restriction would not apply if the shareholding is held through an intermediate holding company that is not subject to French corporate tax.\textsuperscript{25}

For example, consider the structure in Diagram 11 below:
Diagram 11 The requirement of top holding company in France

In this case, Company C can be a parent company of a consolidated group, provided Company B is not subject to French corporate income tax (for example, through a PE in France).\textsuperscript{26} It appears that it is possible for a French group to have more than one consolidated group, for example by inserting non-resident intermediary holding companies between the ultimate French parent companies and its subgroups.\textsuperscript{27} This flexible policy is consistent with the policy of allowing “cherry-picking” of subsidiaries to join consolidation in France.

(b) Subsidiaries:

\textsuperscript{26} IBFD, “Country Analyses - France - Corporate Taxation (online database)” (available at www.ibfd.org), accessed on 28 December 2010, paragraph 8.2.1.

\textsuperscript{27} This rule is more flexible than the Australian MEC group regime, which would not allow the group to be owned by an ultimate Australian resident parent company.
In general, only companies subject to normal French corporate income tax can be a member of a consolidated group.\textsuperscript{28} Since 2005, the following entities also qualify as "subsidiary members" of a consolidated group:\textsuperscript{29}

(1) PE of a foreign company in which at least 95 per cent of its shares are held by the parent company (provided the PE is subject to French corporate income tax); and

(2) a French company in which at least 95 per cent of its shares are held by a PE defined in (1) above.

The entities that are eligible to be subsidiary members of a consolidated group are illustrated in Diagram 12 below:

\textsuperscript{28} Article 223A CGI.

\textsuperscript{29} French Tax Office, Administrative Regulations 19 July 2005: BOI 4 H-2-05; and Mentec, above note 21, at 3.
In this structure, A, B and the PE can consolidate with the parent company.

In general, resident subsidiaries held by non-resident intermediary holding companies are not eligible to consolidate. However, the ECJ concluded in 2008 that the policy was not compatible with the EC law if the intermediate holding company is a resident in a EU member state. The tax law was...
amended accordingly to allow for the so-called “sandwich structure”. This issue is discussed in more detail in Section 5.4 below.

**Italy**

(a) Parent company:

All members of the consolidated group, including the parent company, in general must be residents of Italy. A company is resident of Italy if in broad terms its legal seat, place of effective management or main business purpose is in Italy for the greater part of the tax year.

A non-resident company may also be the head entity of a consolidated group if:

(a) it is a resident in a treaty country; and

(b) it carries on a business in Italy through a PE to which the investment in each resident subsidiary is effectively connected.

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31 Articles 73 & 117 TUIR. The Italian entities eligible as the “controlling company” for consolidation purposes must have the legal form of a limited liability company, including corporations (Società per azioni or S.p.A.), limited liability companies (Società a responsabilità limitata or S.r.l.) and limited partnerships (Società in accomandita per azioni or S.a.p.A.): Francesco Leone and Emiliano Zanotti, “Italian Domestic Tax Consolidation: New Opportunities for Tax Planning” (2005) 45(5) European Taxation 187, at 188.

32 Article 73(3) TUIR. A dual resident company can also be a parent company, provided it is regarded as a resident of Italy under an applicable tax treaty: Marco Q Rossi, “Using Dual-Resident Companies under Italy’s Tax Consolidation Rules” (2006) 44(3) Tax Notes International 205.

33 Article 117(2) TUIR.

34 “Effectively connected” means that the share investment in the Italian subsidiaries is carried in the PE’s books and held as part of the PE’s business. This requirement is to ensure taxing rights over the consolidated group’s taxable income: Adda, above note 5, at 240.
In this case, the consolidation would include income or losses of the non-resident company to the extent attributable to its Italian PE.\textsuperscript{35}

The parent company does not have to be the top holding company in Italy.\textsuperscript{36} Together with the "cherry-picking" policy, membership requirements of the Italian consolidation regime are very flexible. For example, it is possible to have multiple consolidated groups within the same corporate group, as illustrated in Diagram 13 below:\textsuperscript{37}

**Diagram 13 Flexible membership requirements in Italy**

```
Company A
  \rightarrow 100%
  \downarrow
  Company B
    \downarrow 100% 100%
    \rightarrow Company C Company D
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Possible consolidated groups that can be formed by this corporate group include:

\textsuperscript{35} Leone & Zanotti, above note 31, at 196.

\textsuperscript{36} Ibid, at 189.

\textsuperscript{37} This example is based on the Example 6 in Leone & Zanotti: Ibid.
(1) all four companies;
(2) A with any two companies among B, C and D;
(3) A with any one company among B, C and D;
(4) B (as parent company) with C and D;
(5) double consolidated groups: for example, A with C, and B with D.

The very flexible membership rules reflect the primary policy objective of competitiveness of the consolidation regime in Italy.

The main restriction within these flexible rules is that a company can not be member of more than one consolidated group, thus preventing overlap of consolidated groups.\(^{38}\)

(b) Subsidiaries:

In general, all group members of a consolidated group must be resident of Italy. A foreign-incorporated company may join a consolidated group if among other things, it is a resident of Italy under domestic tax law. If it is a dual resident and found to be a non-resident under the tie-breaker rule in a tax treaty, it cannot join a consolidated group.\(^{39}\)

Subsidiaries in general must be limited liability companies.\(^{40}\) In contrast to France, Italy does not have a consistent policy on PEs of non-resident companies. It allows a PE to be the parent company, but not as a controlled entity of the parent company.\(^{41}\)

\(^{38}\) Ibid, at 190.

\(^{39}\) Resolution 123/E of 12 August 2005, issued by the Italian tax administration and cited in Rossi, above note 32.

\(^{40}\) Leone & Zanotti, above note 31, at 188.

\(^{41}\) Ibid, at 196.
The exclusion of PE from being a subsidiary member of a consolidated group may be incompatible with tax treaties and EC law.\textsuperscript{42} In particular, most tax treaties concluded by Italy incorporate the non-discrimination provision (Article 24 paragraph 3) of the OECD Model Tax Convention for permanent establishments. The policy of excluding PEs from consolidating as subsidiary members have been argued to have breached this article.\textsuperscript{43} Furthermore, the policy also seems to be incompatible with the freedom of establishment principle contained in the Treaty on the Functioning of the European Union (previously the EC Treaty).\textsuperscript{44}

\textit{Japan}

(a) Parent company:

The parent company must be a resident and the top holding company of the group in Japan.\textsuperscript{45} A company is a resident in Japan (known as “domestic corporation”) if its head office or main office is located in Japan.\textsuperscript{46} The Company Law and Civil Code in Japan require that all companies incorporated in Japan must have a registered head office or main office in the


\textsuperscript{43} Ibid. However, the current OECD position is that Article 24(3) does not apply to “rules that take account of the relationship between an enterprise and other enterprises ... e.g. rules that allow consolidation ...”: Commentary on Article 24(3) paragraph 41 inserted in 2008.

\textsuperscript{44} Marino & Ballancin, above note 42. The recent ECJ decision on this issue with respect to the French consolidation regime suggests that the Italian regime is more likely to be incompatible with the EC Treaty: see note 30 above.

\textsuperscript{45} Article 4-2 CTA. Certain cooperative associations listed in Schedule No.3 of the Corporation Tax Act may also be the head entity of a consolidated group: Articles 2 item (vii) & 4-2 CTA.

\textsuperscript{46} Article 2 item (iii) CTA.
country. In other word, all companies incorporated in Japan are by
definition residents of the country.

(b) Subsidiaries:
Subsidiaries must be resident corporations in Japan.

The Netherlands
(a) Parent company:
Members of a fiscal unity must be residents of the Netherlands under both
domestic tax law and tax treaty. The exclusion of a dual resident that is
regarded as a non-resident under tax treaty is an anti-avoidance measure
preventing the use of dual resident loss companies.

Entities eligible to be a parent company of a fiscal unity include not only
limited liability companies incorporated in the Netherlands, but also
companies incorporated in an EU member state or a treaty country that
contains a non-discrimination provision provided they are comparable to
Dutch limited liability companies in terms of its nature and organisation.

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47 Hugh J Ault and Brian J Arnold, Comparative Income Taxation: A Structural Analysis
48 Article 4-2 CTA.
49 Article 15(3)(c) Vpb. For example, though a company established in the Netherlands is
generally deemed as a resident, it can not be a group member if its effective management is
outside the country: Rudolf J. de Vries, “Branch Report: Netherlands” in International Fiscal
Association, Cahiers de Droit Fiscal International Volume 89b: Group Taxation (2004), at
469. It was possible for such a company to form a fiscal unity before 2003: Johann Müller,
The Netherlands in International Tax Planning (2005, IBFD, Amsterdam), at 250.
50 Richard van Dam, “Proposed Changes to the Fiscal Unity Regime in the Netherlands”
51 Article 15(3)(d) Vpb.
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The parent company does not have to be the top holding company in the Netherlands. This is consistent with the flexible policy of allowing "cherry-picking" members in the group to consolidate.

Since 2003, the scope of eligible entities to be the head entity of a consolidated group has been expanded to include a PE of a non-resident company, provided investments in the resident subsidiaries are attributable as the assets of the PE.\(^{52}\) Other requirements include, among other things:\(^{53}\)

1. the non-resident’s place of actual management is located in the EU or a treaty country with non-discrimination provision; and
2. the non-resident is a limited liability company, or an entity with comparable nature and organisation.\(^{54}\)

(b) Subsidiaries:

As discussed above, members of a fiscal unity must be a resident of the Netherlands under both domestic law and tax treaty. Excluding residents of another EU member state from the fiscal unity regime has been argued to be incompatible with the EU law.\(^{55}\) However, the ECJ ruled in February 2010

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\(^{52}\) Article 15(4)(c) Vpb; and Vries, above note 49, at 475. The attribution is performed under the "functional analysis": ibid, at 476.

\(^{53}\) Article 15(4)(a)&(b) Vpb.

\(^{54}\) "Comparable nature and organisation" means, among other things, (1) it has equity divided in shares; (2) it is subject to income tax in the country of incorporation; (3) it is not a flow-through entity; (4) its equity providers have limited liability; and (5) its equity providers have voting power proportional to their equity contributions: Müller, above note 49, at 251.

that the Dutch policy of excluding non-resident companies from its fiscal unity regime is compatible with the EU law.\textsuperscript{56}

Subsidiaries can be limited liability companies incorporated in the Netherlands, and companies incorporated outside the country but satisfying the conditions discussed above for a parent company.\textsuperscript{57}

Since 2003, a PE of a non-resident may also join a fiscal unity as a subsidiary member. The requirements are the same as explained above for a parent company. Only profits and losses attributable to the PE that is subject to Dutch income tax are included in the fiscal unity's consolidated results.\textsuperscript{58}

The inclusion of PEs as members of a consolidated group creates some interesting issues on the interactions between the consolidation regime and other parts of the tax system. For analysis of the issues, see Chapter 9 Section 9.2.

\textit{New Zealand}

The consolidation regime in New Zealand has a unique feature: a consolidated group may comprise of brother/sister companies \textit{without} a parent company. \textit{Any 2 or more eligible companies} of a wholly-owned group can form a consolidated group.\textsuperscript{59} The policy deviates from the enterprise doctrine as the

\textsuperscript{56} \textit{X Holding BV} (C-337/08). For a discussion of the judgement, see for example Paulus Merks, "ECJ Accepts Dutch Restriction of Cross-Border Loss Relief" (1 March 2010) \textit{Tax Analysts - Worldwide Tax Daily} (available at \url{www.taxanalysts.com}), accessed on 23 July 2010.

\textsuperscript{57} Article 15(3) (e) Vpb.

\textsuperscript{58} Article 15(4) Vpb.

\textsuperscript{59} Section FM 35(1) ITA 2007.
"all in" rule is not applied. However, it is very flexible and thus achieves the policy objective of competitiveness.

"Eligible company" is defined in general as a company that satisfies the following requirements:60

(1) it must be a resident of New Zealand, and must not be treated as a non-resident under tax treaty; and
(2) it must derive some income other than exempt income.

"Company" is defined as, among other things, "any body corporate or any other entity which has a legal existence separate from that of its members", and the definition specifically includes unit trusts and certain limited partnerships.61 In other words, except for these specified entities, trusts and partnerships in general are not eligible to be members of a consolidated group in New Zealand. It follows that PE of a non-resident company is not eligible to be a consolidated group member.62

The New Zealand tax law specifically disallows a company from being member of more than one consolidated group at the same time, thus avoiding overlap of consolidated groups.63

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60 Section FM 31 2007.
61 Section YA 1 ITA 2007.


63 Section FM 32 ITA 2007.
To deal with the possibility that a consolidated group may not have a parent company, the regime requires that one of the group members be nominated to act in general as the agent for the group and other group members for tax purposes.  

**Spain**

(a) Parent company:

The parent company of a consolidated group must be either:

(1) a resident of Spain, provided that (i) it is subject to normal corporate tax in Spain; and (ii) it is the top holding company in Spain, or

(2) a PE of a non-resident, provided that (i) the investments in subsidiaries are attributable to the PE; (ii) the non-resident must not be a subsidiary of a resident company in Spain that qualifies as a head entity; and (iii) the non-resident must be residing in a treaty country with information exchange clause.

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64 Sections FM 34 ITA 2007.

65 In particular, the resident can be a corporation (known as SA), a limited liability company (known as SRL) or a limited partnership: Section 67(1) LIS. Back in 1982, only SA was allowed as group members: Marfa Amparo Grau Ruiz, “Branch Report: Spain” in International Fiscal Association, *Cahiers de Droit Fiscal International Volume 89b: Group Taxation* (2004), at 615.

66 Section 67(1), & (2)(a)&(d) LIS.

67 The rules of attribution were laid down in Royal Decree 116/2003: Ruiz, above note 65, at 616.

68 Section 67(2)(a)&(f) LIS.
The possibility to have a PE as the head entity was introduced in 2001, due to a combination of reasons including the influence of ECJ judgements, Article 7.2 of the OECD model convention and interest shown by multinationals.\(^69\)

(b) Subsidiaries:
Subsidiaries of a consolidated group must be resident companies subject to normal corporate tax in Spain.\(^70\)

Similar to Italy, the regime is not symmetric for PEs with respect to parent company and subsidiaries. While a PE of a non-resident may be the head entity of a consolidated group, it can not be a subsidiary member.\(^71\)

**The United States**

All members of a consolidated group in the U.S. in general must be "corporations".\(^72\) The term is defined to include "associations, joint-stock companies, and insurance companies".\(^73\) Foreign corporations are specifically

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\(^69\) Ruiz, above note 65, at 616. For a brief discussion of the influence of ECJ judgements, see ibid, at 626-627.

\(^70\) Section 67(1) LIS. In particular, companies subject to a different tax rate to that of the parent company can not be a subsidiary member: section 67(4)(c) LIS.

\(^71\) A stricter entity requirement for subsidiary members is not uncommon. For example, the Dutch fiscal unity regime allows certain cooperative or mutual insurance associations to be the parent company, but not as a subsidiary member: IBFD, "Country Analyses - The Netherlands - Corporate Taxation (online database)" (available at www.ibfd.org), accessed on 20 July 2010, paragraph 8.1. For more examples of a more relaxed entity requirement for parent companies in other group taxation regimes, see Masui, above note 3, at 37. Some Spanish commentators have argued for allowing PEs of non-residents to be subsidiary members: see e.g. Emilio Cencerrado Millán, “Spain” in Guglielmo Maisto (ed), *International and EC Tax Aspects of Groups of Companies*, EC and International Tax Law Series (2008, IBFD, Amsterdam), at 486.

\(^72\) IRC s.1504(a)(1)(A).

\(^73\) IRC s.7701(a)(3).
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excluded from the consolidation regime. 74 This implies that permanent establishments of foreign corporations are also excluded from the regime. 75

In general, all domestic corporations – that is, companies incorporated in the U.S. – qualify to be a consolidated member, except certain domestic corporations that are tax exempt or subject to special tax regimes (for example, an insurance company or a real estate investment company). 76 Foreign incorporated corporations in general are excluded from consolidation, except for certain foreign corporations that have elected to be taxed as a domestic corporation. 77

There is no requirement that the parent company must be the top holding company in the U.S. This flexible policy contrasts with the “all in” rule that applies to the subsidiaries of the parent company.

5.3 Excluded entities

Most countries specifically exclude certain entities from consolidation. Besides non-residents, the most common exclusion is for companies that are not subject to normal corporate income tax rates, for example those subject to a reduced tax rate or exempt from tax. 78

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74 IRC s.1504(b)(3). “Foreign corporation” in general is defined as a corporation that is not created or organised in the U.S.: IRC s.7701(a)(4)&(5). Limited exceptions exist, e.g. certain foreign corporations may elect to be taxed as domestic corporations and as a result are qualified to join a consolidated group: IRC s.1504(d).


76 IRC section 1504(b).

77 For example, certain Canadian and Mexican corporations may elect to be taxed as U.S. corporations: Sparagna, above note 75, at 713.

78 Countries that have this exclusion include: Australia (Section 703-15(2) ITAA1997); Italy (Article 126(1) TUIR); Japan (Article 4-2 CTA; New Zealand (Section FM 31(1)(c) ITA2007; Spain (Article 67(4) LIS); and the U.S. (Section 1504(b)(1)&(2)). The exclusion covers
Companies in bankruptcy and liquidation are also often excluded from a consolidated group.\textsuperscript{79}

Both New Zealand and the U.S. have specific restrictions on companies that are taxed as “flow through” entities.\textsuperscript{80} In particular, New Zealand requires that such companies (known as “qualifying companies”) can only form a consolidated group with each other.\textsuperscript{81} Flow-through entities in the U.S. (for example, S corporations) are not eligible to join any consolidated group.\textsuperscript{82}

A particular feature of the New Zealand regime is that it has a specific exclusion serving as an anti-avoidance provision. A company is not eligible to be a group member if, among other things, the company’s shares are subject to arrangements designed “to defeat the intent and application of the consolidation rules”.\textsuperscript{83} Given the flexibility provided by the regime in terms of membership requirements, it is reasonable to expect such a provision.

5.4 Interposed non-member entities

As discussed in the preceding section, all the eight countries in general exclude non-resident companies from joining a consolidated group. A related
issue is whether a resident subsidiary held through a non-member (for example, a non-resident group company) should be allowed to consolidate. This scenario is depicted in Diagram 14 below:

**Diagram 14 Ownership requirement: interposed non-member entities**

As both the parent company and the subsidiary are residents in the same country and subject to the same corporate income tax law, the issue is whether they should be allowed to consolidate. A strong application of the enterprise doctrine would suggest that they should. However, in practice anti-avoidance concerns often trump the doctrine, preventing the subsidiary from consolidating with the parent company.
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The development in the EU is of particular interest. Decisions of the ECJ are pushing the domestic consolidation regimes towards a stronger application of the enterprise doctrine within the EU boundary.\textsuperscript{84}

The policies of the eight countries on the "sandwich structure" issue are analysed below.

\textit{Australia}

The consolidation regime in Australia prohibits an interposed non-member entity in the holding structure of a consolidated group.

The experience in Australia is telling, as the current policy represents a prompt U-turn of the policy on this issue. When the consolidation regime was first introduced in 2002, it allowed indirect holdings through certain interposed non-resident entities in determining whether a resident company was eligible to be a subsidiary member.\textsuperscript{85} The reason for the exception was to relieve taxpayers from "the burden of restructuring".\textsuperscript{86} However, the policy was quickly abolished in 2003 once the government realised that it did not work with the tax cost setting rules and presented "tax arbitrage opportunities".\textsuperscript{87}

\textit{France}

\textsuperscript{84} For a brief discussion of the issue in the context of the EU, see Masui, above note 3, at 63-64.

\textsuperscript{85} Former section 703-45(3)&(4) ITAA 1997.

\textsuperscript{86} EM to May 2002 Consolidation Act, paragraph 3.85.

\textsuperscript{87} EM to New Business Tax System (Consolidation and Other Measures) Act 2003 ("2003 Consolidation Act"), paragraphs 4.35 & 4.37. There is a transitional provision that permits an interposed foreign company in limited cases. Other limited exceptions include holdings through a non-fixed trust (s.703-40 ITAA1997) and nominee holdings (s.703-45 ITAA1997).
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The consolidation regime in France in general requires that indirect holdings in subsidiaries must be made through "group members". The restriction applies if the subsidiary is indirectly held by another resident company which is not a group member. Consider the following structure in Diagram 15 in which all companies are residents of France and thus subject to French corporate tax:

Diagram 15 Sandwich structure in France

Given the ownership threshold of the consolidation regime in France is 95 per cent, Company A can not be a member of the consolidated group under the parent company. It follows that under Company B can not be a group member, even though effectively the parent company holds 99 per cent in the company. This policy is inconsistent with the enterprise doctrine.

88 Article 223A CGI.
This restriction in general also applies to intermediary non-resident holding companies, and can be justified on policy grounds. As the non-resident company is not under the jurisdiction of the country, it is reasonable to be more cautious and adopt the policy as an anti-avoidance measure.

However, this policy on intermediary non-resident holding company has proved to be problematic in the EU. In 2008, the ECJ ruled in Société Papillon that the policy was incompatible with the EC treaty.89 In particular, the ECJ held that the policy constituted a restriction of the freedom of establishment principle, and resident subsidiaries held through an EU intermediate holding company should be eligible for consolidation in France.90 The French government argued that the policy was necessary to prevent double deduction of losses. However, the ECJ rejected the argument and regarded the policy as “excessive” since other measures were available to deal with the double dip issue. France has amended its law in response to the ECJ decision.91 In particular, effective 31 December 2009, consolidation is now allowed for subsidiaries held indirectly through an intermediary holding company resident in the EU member state with which France has concluded an administrative mutual assistance agreement against tax fraud and tax evasion.

89 Société Papillon v Ministry of Finance (Case C-418/07). Société Papillon was a French parent company which held several French subsidiaries indirectly through a Dutch company that was not subject to French corporate tax.


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The case demonstrates the significant influence of the ECJ in domestic income tax law of the EU member states. Incidentally, it pushes the consolidation regime to be a stronger application of the enterprise doctrine within the EU boundary.

An interesting related issue is whether, if the French rules were amended to allow indirect holding through a non-resident company, the new policy should also apply to indirect holding through a resident non-group member (for example, a “less than 95%” subsidiary). The neutrality principle would suggest so; otherwise the policy would in turn discriminate against resident intermediary holding companies.

Italy
The Italian consolidation regime is more flexible than its French counterpart. It allows a resident subsidiary to join a consolidated group even if the parent company holds it indirectly through a non-group member (for example, a non-resident).\(^92\) New Zealand is the only other country with a similar flexible policy.

Japan
Indirect holding is defined in the Japanese tax law in such a way that the intermediary holding company must be a member of a consolidated group.\(^93\)

The Netherlands
The tax law in the Netherlands specifically requires that indirect holdings in subsidiaries must be held by group members in the fiscal unity.\(^94\)

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\(^{92}\) Leone & Zanotti, above note 31, at 191.

held indirectly by non-resident companies can not form a fiscal unity with the parent company, even though both the parent company and the subsidiaries are residents of the Netherlands.

Some commentators have argued that “it is clear from the ECJ’s case law” that this restriction breaches the EC treaty. Given the recent decision of the ECJ in the French case Société Papillon, the Dutch policy may be under more pressure to be relaxed.

**New Zealand**

In New Zealand, as discussed in Section 5.5 below, the ownership test basically traces to the ultimate non-corporate owners of a company. It implies that interposed non-member companies are allowed in the corporate holding structure for the purpose of determining whether a resident company is eligible to consolidate or not. This flexible policy is unusual: only Italy has a similar rule.

**Spain**

Similar to the Netherlands, Spain specifically excludes from consolidation subsidiaries held indirectly through non-group members. The non-member may be a non-resident company, or a resident company that does not meet the 75 per cent ownership threshold. The policy is under similar pressure from the ECJ decisions as in France and the Netherlands.

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94 Article 15(2) Vpb.

95 Vegt, above note 55, at 418. The comment was made based on specific reference to the ECJ’s verdict in the X & Y case (Case C-200/98).

96 Article 67(4)(d) LIS.


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The United States

The U.S. regime does not allow interposed non-member entities. The ownership test requires specifically shares to be “owned directly” by other includible corporations. 98

5.5 Ownership requirements

The enterprise doctrine premises on the concept of “control”. A corporate group should be treated as one single enterprise if it is under the common control of the parent company. The concept of “control” implies that the group members, though being separate legal entities, are so economically integrated that they should be treated as one enterprise.

In practice, it is not easy to provide a simple and effective definition of “control”. A bright line definition – for example, a minimum percentage of voting rights – may be simple, but may not be effective. “Control” can be established by various means, such as options and convertible securities, control over the composition of the board of directors or key executives, or special shareholders’ agreements. 99 A more general definition – for example, de facto control – may be more effective to capture a “control” relationship, but is difficult to administer as it is “too uncertain and unpredictable”. 100 Most countries adopt the bright line definition, and protect it with supplementary tests and/or anti-avoidance provision.

98 IRC s.1504(a)(1)(B)(ii). This policy was confirmed in American Fork & Hoe Co., 33 BTA 1139 (1936), in which a resident parent company and a resident subsidiary were not allowed to consolidate because all the shares of the latter were owned indirectly by a non-member subsidiary of the parent company.


Besides the factors of control, the other important element in the ownership requirements is the ownership threshold. The minimum ownership percentages vary among the eight countries, but most countries have a high threshold (namely, equal or close to 100%). The high ownership threshold can be justified for the following reasons:

(1) Neutrality:
Under the enterprise doctrine, a subsidiary under the control of a parent company should be treated the same as a branch of the latter. To justify this treatment under the neutrality principle, the parent company should wholly own the subsidiary without any minority interest. In other words, the ownership threshold should be 100 per cent.\(^{101}\)

(2) Revenue concern:
As loss offset among group members is likely to impact adversely on revenue, governments may try to minimise the impact by restricting access to the regime with a higher threshold.\(^{102}\)

(3) Minority interests:
The presence of minority interests introduces complexity into the consolidation regimes.\(^ {103}\) A 100 per cent ownership threshold avoids the problem.

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\(^{101}\) Many countries allow a small percentage to be owned by employees through employee share schemes. This policy is pragmatic and reasonable, as this kind of holding in general does not affect significantly the control of the parent company over the subsidiary.

\(^{102}\) For example, the Dutch government was reluctant to lower the 95 per cent threshold for the revenue concern: Vries, above note 49, at 471.

\(^{103}\) During the design phase of the Australian consolidation regime, U.S. officials specifically warned their Australian counterparts not to allow minority interest in subsidiaries as the U.S. does: Geoffrey Lehmann, "An Assessment of Australia’s Tax Consolidation Regime" in
Corporate groups in practice do not have major objection to a high ownership threshold. Given the significant benefit of intra-group loss offsetting and tax free asset transfers, it is reasonable to expect a strict ownership requirement to screen for eligible group members. Furthermore, in practice, many subsidiaries of corporate groups are wholly-owned for commercial reasons. Therefore, a high ownership threshold in general does not pose significant obstacle to consolidate.

The policies of the eight countries on the issues of ownership requirements are analysed in the following material.

**Australia**

In Australia, all subsidiary members must be a wholly-owned subsidiary of the head company. Certain ordinary shares issued under employee share scheme, up to one per cent, are ignored for the “100% threshold” purpose.

An important question is to what the 100 per cent refers. The test in Australia is not based on the common criteria of control, namely voting rights, or value of the interest in an entity. Instead, it is defined in a convoluted way, based on

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104 In Australia, it was found that over 90 per cent of subsidiaries in listed corporate groups were wholly-owned subsidiaries: Ian M Ramsay and G Stapledon, “Corporate Groups in Australia” (2001) 29(1) *Australian Business Law Review* 7.

105 As this thesis focuses on corporate groups, issues of “ownership” in partnerships and trusts are not discussed in detail. For analysis of the issues, see Ting, above note 1, at 328.

106 Section 703-15(2) item 2 column 4 ITAA 1997. Similar requirement applies to MEC group pursuant to s.719-10(1)(b) column 3 ITAA 1997. The “100%” requirement is historical: the old group loss transfer rules applied only to wholly owned groups: Subdivision 170-A ITAA 1997.

107 Section 703-35(4) ITAA 1997.
an invented concept of “membership interest” in an entity.\textsuperscript{108} The term is defined as the interest or right in the entity “by virtue of which you are a member of the entity”.\textsuperscript{109} That in turn begs for the meaning of “member”. A member of a company is defined to be “a member of the company or a stockholder in the company”\textsuperscript{(emphasis added)}.\textsuperscript{110}

The definitions warrant some discussion. Under company law, for incorporated companies limited by shares, shareholders are their members.\textsuperscript{111} “Membership interest” in these companies refers to the shares issued by the company, including both ordinary and preference shares. The ownership test therefore focuses solely on the legal form of ownership, and fails to consider the criterion of either voting rights or value of the interest.

The definition creates potential for abuse. For instance, all the shares of Company A may be wholly-owned by Company B, but another company may effectively control A by holding options over the shares in A.\textsuperscript{112} Under Australia’s consolidation regime, A and B can form a consolidated group, even though A is not in substance controlled by B.

\textsuperscript{108} Section 703-30 ITAA 1997. “Membership interest” specifically excludes a “debt interest” as determined under the debt/equity test in the tax law: section 960-130(3) ITAA 1997. The debt/equity test is contained in Division 974 ITAA 1997. However, the government does not define “membership interest” to include an “equity interest” as determined under that test. It is not clear why the government decided not to do so.

\textsuperscript{109} Section 960-135 ITAA 1997.

\textsuperscript{110} Section 960-130(1) ITAA 1997. This circular definition of “a member of a company is a member of a company” has been a favourite joke among tax practitioners.

\textsuperscript{111} Peter Lipton and Abe Herzberg, \textit{Understanding Company Law} (2008, Lawbook, Pyrmont), at 209.

\textsuperscript{112} In contrast, both New Zealand and the U.S. have special provisions to deal with options and other financial instruments in their consolidation regimes. See discussions below for more detail.
Indirect holdings can be determined by simply adding up the percentage holdings by the parent company and other group members, as the ownership threshold is set at 100 per cent and intermediate non-member holdings are not allowed.

**France**
A parent company may consolidate with its subsidiaries in which it holds at least 95 per cent of shares directly or indirectly through group members.\textsuperscript{113} The 95 per cent threshold is applied in terms of both share capital and voting rights.\textsuperscript{114} Shares granted to employees, up to 10 per cent of the share capital, do not prevent the parent company from satisfying the threshold requirement.\textsuperscript{115}

For the purpose of determining the indirect ownership level, a holding of 95 per cent or more is deemed to be 100 per cent.\textsuperscript{116} This “deemed 100\%” policy is reasonable given a high ownership threshold and reflects properly the enterprise doctrine.

**Italy**
The ownership threshold in Italy is the lowest among the eight countries. Each subsidiary must be “controlled” by the parent company in the following ways:\textsuperscript{117}

\textsuperscript{113} Article 223A CGI.


\textsuperscript{115} Ibid, at 289.

\textsuperscript{116} Knoepfler & Anderson, above note 22, at 171; and IBFD, “Country Analyses - France - Corporate Taxation (online database)” (available at [www.ibfd.org](http://www.ibfd.org)), accessed on 28 December 2010, paragraph 8.2.1.

\textsuperscript{117} Articles 117 & 120 TUIR.
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(a) the parent company has the majority of voting rights at ordinary shareholders’ meetings of the subsidiary;\textsuperscript{118}

(b) the parent company holds directly or indirectly more than 50 per cent of the authorised share capital (excluding shares that do not carry voting rights in the shareholders’ general meeting); and

(c) the parent company is directly or indirectly entitled to more than 50 per cent of the profits of the subsidiary company (excluding profits attributable to shares that do not carry voting rights in the shareholders’ general meeting).

Test (a) is based on the company law concept of “controlled companies.”\textsuperscript{119} Tests (b) and (c) are specific to the tax law. The tests apply differently to indirect shareholdings. For instance, assume that Company A owns 51 per cent of Company B, which in turn owns 51 per cent of Company C. For company law purposes, A controls B which in turn controls C. It implies that A is regarded as controlling C, and therefore satisfies test (a).\textsuperscript{120}

However, indirect holdings are determined on the “multiplication” approach under tests (b) and (c),\textsuperscript{121} meaning that Company A is regarded as holding

\textsuperscript{118} This is one of the three situations under which a company is defined to be “controlled” by another company under the Civil Code: Articles 2359, paragraph 1, number 1) & 2346 of the Civil Code. The other two situations are (i) a company has sufficient votes to exercise a dominant influence in the ordinary shareholders’ meetings of the other company; and (ii) a company is under dominant influence of the other company by virtue of specific contractual relations. These two definitions are not adopted in the consolidation regime, presumably because they are too uncertain to administer in practice for tax purposes.

\textsuperscript{119} Articles 2359, paragraph 1, number 1) & 2346 of the Civil Code.

\textsuperscript{120} Leone & Zanotti, above note 31, at 189.

\textsuperscript{121} Article 120(1) TUIR.
only 26 per cent in Company C for the purposes of the two tests. Therefore, A cannot consolidate with C.

This multiplication approach for indirect holding is reasonable for the relatively low ownership threshold of 50 per cent in Italy. The possible presence of significant minority interests in the company chain makes the “deemed 100%” approach (similar to that of France) inappropriate.

The unusually low threshold of 50 per cent may be due to historical reasons. Before the consolidation regime was introduced, Italy had an “implicit” group taxation regime, known as the “excess imputation credit surrender” regime.122 In broad terms, the regime allowed intra-group loss utilisation by surrendering excess tax credit of a loss company to its profitable subsidiary. One of the key requirements of the regime was that the ownership threshold between the two companies was more than 50 per cent. This perhaps has some bearing on the 50 per cent ownership threshold in the consolidation regime.

It appears that there is no specific rule on employee share schemes for the purpose of the 50 per cent ownership test. However, given the low threshold, such a specific rule is most likely unnecessary, as in practice shares held under employee share schemes would most likely be significantly less than 50 per cent.

**Japan**

The consolidation regime in Japan requires a parent company to have “perfect control relation” with its subsidiaries. This means that the parent company

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must hold directly or indirectly 100 per cent of shares in the subsidiaries.\textsuperscript{123} Shares held under employee share schemes, up to a maximum of five per cent, are excluded for the purpose of determining the level of shareholdings.\textsuperscript{124}

As intermediary non-member entities are not allowed in the structure of a consolidated group and the ownership threshold is 100 per cent, indirect holdings are determined simply as the sum of holdings by the parent companies and its wholly owned subsidiaries.\textsuperscript{125}

\textit{The Netherlands}

A parent company can form a fiscal unity with a subsidiary if it holds at least 95 per cent of the nominal paid-up share capital of the latter.\textsuperscript{126} "Holding" for this purpose means both legal ownership and the entire economic interest in the shares.\textsuperscript{127} "Economic interest" includes profit and equity rights, but it appears that voting right is not considered as a relevant factor for this purpose.\textsuperscript{128} The 95 per cent test excludes shares that are held by the parent company as trading stock.\textsuperscript{129}

If a company has different classes of shares, the parent company is required to hold at least 95 per cent in each class of shares.\textsuperscript{130}

\textsuperscript{123} Article 4-2 CTA.
\textsuperscript{124} Gomi & Honjo, above note 93, at 53.
\textsuperscript{125} Ibid, at 55.
\textsuperscript{126} Article 15(1) Vpb.
\textsuperscript{127} Vries, above note 49, at 469
\textsuperscript{128} Müller, above note 49, at 248.
\textsuperscript{129} Article 15(3)(f) Vpb.
\textsuperscript{130} Vries, above note 49, at 470-471.
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The ownership threshold was relaxed from 100 per cent\textsuperscript{131} to 95 per cent in 2003 for the following reasons:\textsuperscript{132}

(1) the reduced threshold was designed to cater for employee share schemes; and

(2) it allows fiscal unity even if the parent company fails to acquire the very last shares in an acquired company.

The government refused to adopt a lower threshold partly due to budgetary concerns.\textsuperscript{133} It also reflects the government’s belief that the fiscal unity regime should be available only to groups that are “both legally and economically unified”.\textsuperscript{134} The policy reflects a strong application of the enterprise doctrine.

*Indirect ownership is computed based on the “multiplication” approach.*\textsuperscript{135} In contrast, France – which has the same high ownership threshold of 95 per cent – adopts the “deemed 100%” approach in determining level of ownership for indirect holdings.

**New Zealand**

In New Zealand, any two or more eligible companies are entitled to be members of the same consolidated group if those companies are members of a

\begin{itemize}
  \item \textsuperscript{131} The 100% threshold in practice required only 99% shareholding, provided that the remaining shares were not entitled to more than 1% of the profits and assets of the subsidiary: ibid., at 469.
  \item \textsuperscript{132} Dam, above note 50, at 119; and Eric van der Stoel, “Analysis of Proposed Amendments to Dutch Fiscal Unity Rules” (2001) 23(1) *Tax Notes International* 13, at 16.
  \item \textsuperscript{133} Vries, above note 49, at 471.
  \item \textsuperscript{134} Vegt, above note 55, at 383.
  \item \textsuperscript{135} Vries, above note 49, at 470.
\end{itemize}
wholly-owned group of companies. For the purposes of determining the ownership level, up to three per cent of shares held by employees under an employee share scheme are ignored.

Companies are treated as a "wholly-owned group of companies" if, among other things, there is a group of persons whose aggregate common voting interest in the companies is 100 per cent. "Common voting interest" of a person in the companies is defined as "the lowest of percentage voting interests of the person in each of the companies ...". "Voting interest" is defined in detail and counts both direct and indirect holdings through companies. In effect, the voting interest test traces to the ultimate non-company owners of the interest.

In addition to the voting interest test, companies are subject to a "market value" test if, among other things:

- any of the companies has on issue a floating rate debenture tied to the company's profits or distribution,

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136 Section FM 35(1) ITA 2007.
137 Section IC 4(2) ITA 2007.
138 Section IC 4 ITA 2007.
139 Section IC 3(3) ITA 2007. This rule implies that, in the context of a "100%" requirement, each person's voting interest must be the same in each of the companies. This position is confirmed in IRD, Tax Information Bulletin, Vol.4, No.5, p.4.
140 "Voting interest" is defined basically as the average of four "shareholder decision-making rights" in respect of the company carried by shares or options held by the person. The 4 rights are in respect of dividend/distribution, company constitution, variation of company capital, and appointment of directors: sections YA 1 & YC 2 ITA 2007.
141 Section YC 4 ITA 2007.
142 Sections IC 4(1)(b) & YA 1 ITA 2007. The "market value" test is intended to apply only where the "voting interest" test will not accurately reflect the true proportion of economic interests held in a company; CCH New Zealand, New Zealand Income Tax Law and Practice (Looseleaf) (2001, CCH, Auckland), paragraph 645-060.
- an option to buy or sell a share in any of the companies exists, or
- there is an arrangement "in respect of shares or options over shares in
the company … which has a purpose or effect of defeating the intent and
application of any provision of this Act whose application is dependent
upon measurement of voting and market value interests …".

The market value test basically calculates the percentage of the total market
value of shares or options over shares in the company that are held by the
person.\textsuperscript{143}

Some observations can be made on New Zealand’s ownership requirements.
First, the New Zealand regime allows companies owned by multiple
shareholders to consolidate. Consider the following structure in Diagram 16:

\textsuperscript{143} Section YC 3 ITA 2007.
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Diagram 16 Multiple owners of consolidated group in New Zealand

The common voting interest of Mr. X in Companies A and B is 50 per cent and the same for Mr. Y. Together these two persons own 100 per cent of common voting interests in the two companies. Therefore, the two companies satisfy the voting interest test and can consolidate. This outcome is unique among the eight countries.\textsuperscript{144} The design of the ownership test also automatically caters for what would be MEC groups in Australia to consolidate. There is no need for a separate regime for such groups. The legislation is therefore simpler and more effective in this respect.

Second, the market value test is triggered whenever there is an avoidance arrangement involving shares and options. In addition, a company is

\textsuperscript{144} It is interesting to note that the U.S. originally allowed brother-sister corporations to consolidate, but the possibility was removed in 1928. See Andrew J Dubroff et al, \textit{Federal Income Taxation of Corporations Filing Consolidated Returns} (2003, Lexis Nexis Matthew Bender, New York), paragraph 1.02.
prevented from becoming a member of a consolidated group if its shares or any rights attaching to them have been subject to any avoidance arrangement. These anti-avoidance provisions are necessary given the critical importance of the ownership test in a consolidation regime.

Spain

In Spain, to be eligible to consolidate, a parent company in general is required to have a direct or indirect interest of at least 75 per cent of the share capital of a subsidiary. Since 1 January 2010, the ownership threshold is reduced to 70 per cent if the subsidiary is a listed company. Organisational or economic integration is not required. It also appears that voting right is not a relevant factor in the ownership test.

The ownership threshold has been fluctuating over the years. It was 50 per cent when the consolidation regime was introduced in 1977, increased substantially to 90 per cent in 1982, and reduced down to 75 per cent in 2002.

The 75 per cent threshold has been described as “restrictive … [and offering] more leeway for tax planning, because the results can be realised through transactions with external companies (including companies in which the dominant entity has up to 74 per cent holding) whenever it suits the dominant

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145 Section FM 31(6) ITA 2007.
146 Section 67(2)(b) LIS.
148 Stepholt, above note 97, at 405.
entity". This observation contrasts the Australian approach under which a 100 per cent ownership threshold is regarded as serving an anti-avoidance objective.

Indirect holding is determined by the multiplication approach. As discussed above in the context of the ownership threshold in Italy, this policy is reasonable for a relatively low threshold of 75 per cent.

**The United States**

In the U.S., a parent company can consolidate with its subsidiaries provided it holds at least 80 per cent of both the voting power and the value of the shares in the subsidiaries.

The law specifically excludes a preference share from the test if, among other things, it is "not entitled to vote ... does not participate in corporate growth to any significant extent, ... and ... is not convertible into another class of stock". There are also detailed rules dealing with the treatment of warrants, options, convertible obligations, and other similar interests.

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150 Ruiz, ibid, at 614. The 75% threshold appears to be restrictive especially when compared with the 50% threshold in the definition of a group under the company law: ibid, at 613. For more detail of the company law definition and the comparison between the two definitions, see Millán, above note 71, at 448 and 461-462.

151 Section 69(1) LIS.

152 IRC s.1504(a)(1) & (2). The "value" test was added in 1984 as an anti-avoidance measure. For a discussion of the abuses targeted by the measure, see Dubroff, above note 144, paragraph 11.03[4]. For specific rules on valuation of shares, see Hennessey, above note 15, paragraph 2.02[1][a].

153 IRC s.1504(a)(4).

154 Reg. 1.1504-4.
All classes of shares (except the above-mentioned preference shares specifically excluded) are combined in determining whether the test is satisfied.  

The ownership threshold of the consolidation regime in the U.S. has evolved over the years. When the regime was first introduced in 1917, it required that the parent company had to own “substantially all” shares of another company. The threshold was changed to “95% of voting stock” in 1924. The test was amended in 1942 to require ownership of 95 per cent of voting power of all classes of shares and 95 per cent of non-voting shares.

The threshold was reduced to 80 per cent in 1954, thus allowing more companies to consolidate. Since 1984, the ownership test was strengthened by adding the “80% value” test primarily as an anti-avoidance measure.

Similar to France, for the purpose of determining indirect ownership level, holding of 80 per cent or more is deemed to be 100 per cent. This policy,

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155 Hennessey, above note 15, paragraph 2.02[1][d].
156 For more information on the historical development of the ownership requirement and other features of the U.S. consolidation regime, see ibid, Chapter 1.
157 Remembering that the consolidation regime in 1917 was mandatory and basically an anti-avoidance measure, the “substantially all” test did not mean a fixed percentage, but was determined based on the facts of each particular case: ibid, paragraph 1.04[2][a].
158 This change maintained focus on “voting control” of a corporation, in addition to economic ownership: ibid, paragraph 1.11.
159 Ibid, paragraph 1.13. Similar 80% threshold was introduced in other sections of the tax law, including corporate reorganisations, formation and liquidation of subsidiaries. However, the detailed definitions of the 80% tests in these regimes are often different, demonstrating “an ad-hoc and sporadic approach of the [Internal Revenue Code] to ownership relationships at the definitional level with very little consistency”: Yariv Brauner, “United States”, in Guglielmo Maisto (ed), International and EC Tax Aspects of Groups of Companies, EC and International Tax Law Series (2008, IBFD, Amsterdam), at 509-510.
160 Hennessey, ibid, paragraph 1.18; and Dubroff, above note 144, paragraph 11.03[4].
161 IRC s.1504(a)(1)(B)(ii).
coupled with the relatively low ownership threshold of 80 per cent, may allow a company to join a consolidated group even though the parent company owns effectively less than 50 per cent of its shares. Consider the scenario in Diagram 17 below:

**Diagram 17 Issues of indirect holding in the United States**

Company A can form a consolidated group with all four subsidiaries, including Company E in which it effectively owns only 41 per cent (namely, $80\% \times 80\% \times 80\% \times 80\%$). This is an uncommon feature for a consolidation regime. Among the five countries with an ownership threshold of less than 100 per cent, France is the only country besides the U.S. that adopts the
“deemed 100%” rule for the purpose of determining indirect ownership level. However, the French ownership threshold is much higher, namely 95 per cent. It implies that the French regime can allow a “less than 50%” subsidiary to join a consolidated group only if the group has at least fourteen levels of subsidiaries. It is unlikely that in practice a group would have such a long chain of companies.

Another feature of the U.S. regime is that shares owned under employee share schemes are not excluded for the purpose of the “80% voting and value” test. Nevertheless, the policy should not have significant implications in practice, as the relatively low threshold of 80 per cent should be enough to cater for such shares in most cases.

The ownership tests in the U.S. are protected by specific anti-avoidance provisions, including detailed anti-avoidance rules for options, warrants, and convertible instruments. Furthermore, if a corporation leaves a consolidated group, in general it cannot re-enter a consolidated group with the same common parent within 5 years.

5.6 Change of parent company

Some countries have specific provisions to deal with the change of the parent company in a consolidated group, for example due to a merger or an acquisition of the parent company. In general, the policy is to allow the consolidated group to continue to exist in these circumstances. For example, in France, if a company absorbs a parent company of a consolidated group

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162 Hennessey, above note 15, paragraph 2.02[1][e].

163 Reg. 1.1504-4. For instance, options may be counted as “stock” for the “value” test if, among other things, their issue or transfer would result in substantial tax savings: Reg. 1.1504-4(b)(2).

164 IRC s. 1504(a)(3).
under a merger, it can elect to assume the position of the original parent company and continue the consolidation provided it satisfies the requirements of being a parent company under the consolidation regime. Australia, Italy and the U.S. have similar provisions dealing with reorganisations involving the parent company.

The New Zealand regime provides a unique and flexible approach to deal with this issue. As discussed above, it does not require a parent company to be in a consolidated group at all. Instead, it only requires a member of the consolidated group to be the “nominated company”, which is treated as the agent for the group and each member of the group. Furthermore, a consolidated group is free to nominate any group company to replace the existing nominated company. In terms of changing parent companies, the New Zealand regime offers the maximum flexibility among the eight countries.

5.7 Conclusion
The policies of the two key elements in the definition of a group in the eight consolidation regimes are summarised in Table 4 below:

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165 Article 223L(6)(e) CGI. Similar rule applies to acquisition and spin-off of a parent company: Article 223L(6)(d)&(e) CGI.

166 Section 703-65 ITAA1997 (Australia); Article 124(5) TUIR (Italy); and Reg.1.1504-75(d) (the U.S.).

167 Section FM 34(2) ITA 2007.

168 Section FM 34(3) ITA 2007.
### Table 4: Key issues of the definition of a group in the eight countries

<table>
<thead>
<tr>
<th>Eligible entities</th>
<th>Country</th>
<th>Australia</th>
<th>France</th>
<th>Italy</th>
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<th>Netherlands</th>
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<td>✔</td>
<td>✗</td>
<td>✗</td>
<td>✔</td>
<td>✓</td>
<td>✗</td>
<td>✓</td>
</tr>
<tr>
<td></td>
<td>Top resident parent company</td>
<td>✔</td>
<td>✔</td>
<td>✗</td>
<td>✔</td>
<td>✗</td>
<td>✓</td>
<td>✗</td>
<td>✓</td>
</tr>
<tr>
<td></td>
<td>Interposed non-member</td>
<td>✗</td>
<td>✗</td>
<td>✔</td>
<td>✗</td>
<td>✔</td>
<td>✓</td>
<td>✗</td>
<td>✓</td>
</tr>
<tr>
<td></td>
<td>Brother-sister companies</td>
<td>✗</td>
<td>(Note)</td>
<td>✗</td>
<td>✗</td>
<td>✗</td>
<td>✓</td>
<td>✗</td>
<td>✓</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Definition of “control”</th>
<th>Country</th>
<th>Australia</th>
<th>France</th>
<th>Italy</th>
<th>Japan</th>
<th>Netherlands</th>
<th>NZ</th>
<th>Spain</th>
<th>US</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ownership threshold</td>
<td>100%</td>
<td>95%</td>
<td>50%</td>
<td>100%</td>
<td>95%</td>
<td>100%</td>
<td>75%</td>
<td>80%</td>
<td></td>
</tr>
<tr>
<td>Voting right as factor?</td>
<td>✗ (shares)</td>
<td>✔ (+ shares)</td>
<td>✔ (+ shares &amp; profit right)</td>
<td>✗ (shares)</td>
<td>✗ (shares, equity &amp; profit right)</td>
<td>✔ (+ value)</td>
<td>✗ (shares)</td>
<td>✔ (+ value)</td>
<td></td>
</tr>
<tr>
<td>Indirect holdings</td>
<td>n/a</td>
<td>Deemed 100%</td>
<td>Multiplication</td>
<td>n/a</td>
<td>Multiplication</td>
<td>n/a</td>
<td>Multiplication</td>
<td>Deemed 100%</td>
<td></td>
</tr>
</tbody>
</table>

**Note:** Except for subsidiaries held by intermediate holding companies resident in EU member states.

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With respect to the first key element of “eligible entities” to consolidate, all the eight countries exclude non-resident companies from their consolidation regimes. In contrast, they are divided on the issue of whether a PE of a non-resident company is eligible to consolidation. All the four EU countries allow PEs to join consolidation, but not so for the other four non-EU countries. The inclusion of PEs in a consolidated group in the EU countries is a response to the pressure from some ECJ decisions. Nevertheless, among the four EU countries, the policy is inconsistent between parent company and subsidiary. While France and the Netherlands have a consistent policy of allowing PEs to be the parent company and subsidiary members in a consolidated group, Italy and Spain only allow so for the parent company but not for subsidiaries.

All the eight countries except Italy and New Zealand exclude subsidiaries owned indirectly through non-group members. France provides an exception to this rule if, among other things, the intermediate holding company is a resident in a EU member state. The policy of excluding subsidiaries held under a “sandwich structure” deviates from the enterprise doctrine, but can be justified on anti-avoidance grounds.

The policies in the eight countries are similarly convergent with respect to the issue of “brother-sister companies”. All of them, except Australia and New Zealand, do not allow brother-sister companies to consolidate without a parent company. New Zealand has the most flexible rule on this issue. It is the only country that in general allows brother-sister companies to consolidate. Australia fails to have a consistent policy between domestically-owned and foreign-owned groups. It requires the parent company to be in a consolidated group for domestically-owned groups, but allows brother-sister companies to consolidate under the MEC group rules for foreign-owned groups. The policy
objective of competitiveness appears to have a significant influence in shaping the policies of "brother-sister companies" in these two countries.

In contrast, the eight countries are divided on the issue of whether the top parent company must be included in consolidation. Four countries – Australia, France, Japan and Spain – require so, while the other four countries do not. One may expect that if a country insists on having the top parent company to be in a consolidated group, it would apply consistently the strict policy for subsidiaries, namely imposing the "all in" rule. However, that is not always the case in the eight countries. Table 5 below summarises the policies in the eight countries:

**Table 5 Policies of the “all in” rule and “top parent company” in the eight countries**

<table>
<thead>
<tr>
<th>Countries</th>
<th>Aus</th>
<th>France</th>
<th>Italy</th>
<th>Japan</th>
<th>Neth.</th>
<th>NZ</th>
<th>Spain</th>
<th>US</th>
</tr>
</thead>
<tbody>
<tr>
<td>&quot;All in&quot; rule</td>
<td>✓</td>
<td>x</td>
<td>x</td>
<td>✓</td>
<td>x</td>
<td>x</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>(except MEC</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>groups)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Top</td>
<td>✓</td>
<td>✓</td>
<td>x</td>
<td>✓</td>
<td>x</td>
<td>x</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>parent</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>company</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Five countries – Italy, Japan, the Netherlands, New Zealand and Spain – have consistent attitude towards the two policies. Italy, Netherlands and New Zealand are consistently relaxed, while Japan and Spain are consistently strict. France and the U.S. exhibit contrasting attitude towards the two policies. The U.S. imposes the "all in" rule while allowing the top parent company in a
group to be left out of consolidation. The inconsistent policies compromise the anti-avoidance objective of the “all in” rule. Australia has a consistent strict attitude for domestically-owned groups. However, the rules for foreign-owned groups are more flexible and thus fail to provide a level playing field for the two classes of corporate groups.

With respect to the second key element of the definition of a group, namely the definition of “control”, five countries – Australia, France, Japan, the Netherlands and New Zealand – have an ownership threshold equal or close to 100 per cent. The high threshold minimises the issue of minority interests, and is in accordance with the enterprise doctrine. Italy has an unusually low ownership threshold of 50 per cent which may reflect the desire to make the consolidation regime more accessible to corporate groups. The policy suggests a strong influence of its policy objective of competitiveness. The ownership thresholds in Spain (75%) and the U.S. (80%) have changed over the years, suggesting the absence of a dominant policy objective on the issue. The two thresholds may reflect a compromise between the policy objective of competitiveness and the minority interest concerns.

The eight countries are divided with respect to the calculation method of the ownership threshold for indirect holding. It is a non-issue for three countries – Australia, Japan and New Zealand – which have a 100 per cent ownership threshold. Among the remaining five countries, three countries – Italy, the Netherlands and Spain – adopt the multiplication method, while France and the U.S. adopt the “deemed 100%” approach. It is difficult to decide which approach is better. While the “deemed 100%” approach is consistent with the enterprise doctrine, the multiplication method minimises the risk of having substantial minority interests in lower level subsidiaries. This issue is especially pressing for Italy and Spain which have a relatively low ownership
threshold. The adoption of the multiplication method for indirect holding is therefore justified. In contrast, the "deemed 100%" approach in the U.S., coupling with the relatively low ownership threshold of 80 per cent, can create significant minority interests and has proved to be problematic.

The eight countries are also divided in terms of the factors of "control". Three countries – Australia, Japan and Spain – adopt shareholding as the sole factor, while three countries – France, Italy and the Netherlands – also adopt shareholding as a factor, but in conjunction with other factors such as voting rights. Shareholding as a factor is simple to administer, but prone to abuse. It should be protected by other factors and/or specific anti-avoidance provisions. For example, the Dutch definition covers not only legal ownership of shares, but also the entire economic interests in the shares; Japan has a provision which empowers the tax authority to adjust the consolidated tax liability if it considers that the tax liability has been "improperly reduced". Both New Zealand and the U.S. focus on the factor of voting rights as the primary test of "control", which is supplemented by a value test.

The only consistent policy among the eight countries in the definition of control is that none of them has a definition based on de facto control. It is a strong indication that the de facto control test is widely regarded as too uncertain and difficult to administer in practice.

The analysis above reveals the divergent policies in the eight countries in their definitions of a group. It demonstrates the difficulties of applying the enterprise doctrine in practice. Policy choices often represent a trade-off between competing policies and conflicting constraints. In addition to the traditional tax policy objectives of simplicity and neutrality, governments
often have to take into consideration other policy objectives including competitiveness and anti-avoidance in designing a consolidation regime.

The next chapter deals with another key structural element of a consolidation regime: the treatment of losses. Intra-group loss offset is one of the most important benefits of consolidation. The comparative study of the treatment of losses in the eight countries covers the issues of pre-consolidation losses at joining time, during consolidation and at leaving time. It also analyses the treatment of consolidated group losses during consolidation, at leaving time and de-consolidation.
6.1 Introduction
This chapter analyses and compares the treatment of losses in the consolidation regimes in the eight countries. The possibility of intra-group loss offset is one of the major advantages of consolidation.1

Issues of losses in the context of consolidation include:

(1) the treatment of pre-consolidation losses at joining time (that is, when a subsidiary joins a consolidated group), during consolidation and at leaving time (that is, when a subsidiary leaves a consolidated group); and

(2) the treatment of group losses during consolidation, at leaving time and at de-consolidation (that is, when the whole group ceases consolidation).

As the focus of the discussion is the policies on losses in the consolidation regimes, anti-loss-trafficking rules and their application to consolidated groups

1 For instance, it is possibly the most important factor inducing corporate groups to consolidate in the U.S.: Lloyd W Herrold, “Consolidated Return Considerations in a Period of Transition” (1970) 22(3) Tax Executive 177, at 186.
are not discussed in detail in this thesis. Furthermore, in the following discussion, anti-loss-trafficking rules in the eight countries are assumed to be satisfied, unless stated otherwise.

6.2 Pre-consolidation losses

This section first provides the policy analysis of the alternative treatment of pre-consolidation losses of a subsidiary. The treatment of such losses in the eight countries at the joining and leaving time are then compared and analysed in Sections 6.2.1 and 6.2.2 respectively.

Pre-consolidation losses pose some difficult questions. The key issue is how losses incurred by a subsidiary before joining time should be treated. This is basically an issue about the transition between the enterprise doctrine and the separate entity doctrine. At joining time, the enterprise doctrine implies that the subsidiary becomes part of the enterprise controlled by the parent company. Its taxable income and losses generated during consolidation should be treated as those generated by the enterprise as a whole. However, pre-consolidation losses are incurred by a subsidiary when it is treated as a separate taxpayer under the separate entity doctrine. This raises the question of whether pre-consolidation losses should be allowed to offset against consolidated group’s taxable income.

Possible policies on pre-consolidation losses include:

(1) Cancellation:

A possible policy is to cancel any pre-consolidation losses of a company when it joins consolidation. Though the policy is simple to operate, the enterprise doctrine does not suggest this harsh policy. More importantly, in practice
outright cancellation of the losses would make the consolidation regime less attractive to taxpayers.

(2) Suspension:
An alternative policy is to suspend pre-consolidation losses during consolidation. The losses are available to the company again when it leaves consolidation. The policy may be justified on the ground that a company is deemed to have become part of the enterprise of the parent company during consolidation. As it is regarded to have lost its individual identity during consolidation, its pre-consolidation losses – which are incurred by the company under the separate entity doctrine – should not be available to the company until it becomes a separate taxpayer again when it leaves consolidation. However, similar to the cancellation policy, the suspension policy would render the consolidation regime less attractive to taxpayers. In practice, none of the eight countries adopts this policy in their consolidation regimes.2

(3) Quarantine:
Under the quarantine policy, pre-consolidation losses incurred by a joining subsidiary are quarantined and available to offset only against taxable income generated by that subsidiary.3 The policy rationale for quarantine is that as the

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3 In the CCCTB experience, most EC experts preferred the quarantine option, as the pre-consolidation losses were calculated under national tax rules which might be inconsistent with the CCCTB rules: See for example European Commission, “An overview of the main issues that emerged at the second meeting of the subgroup on group taxation” (CCCTB\WP\048, CCCTB WG, 2006), paragraph 10; European Commission, “An overview of the main issues that emerged at the third meeting of the subgroup on group taxation” (CCCTB\WP\053,
Chapter 6 Treatment of Losses

pre-consolidation losses are incurred when a subsidiary is treated as a separate taxpayer, those losses should remain in the hands of the subsidiary and be available for offset against its own future taxable income. A pre-requisite for this policy is that the subsidiary maintains its separate identity to a large extent for income tax purposes during consolidation.

If the pre-consolidation losses are quarantined, the question is whether they should be available for offset before or after losses of other consolidated group members incurred during consolidation. This is an issue arising from the tension between the two doctrines. Pre-consolidation losses are generated under the separate entity doctrine. This raises the issue of whether it implies that the doctrine should have priority over the enterprise doctrine and continue to apply to those losses until they are fully utilised by the company, or the enterprise doctrine should prevail and the losses be available first to offset against the group’s tax base under the enterprise doctrine.

Under the enterprise doctrine, once the transition to the enterprise doctrine occurs at joining time, the subsidiary’s taxable profits should be incorporated into the computation of the group’s taxable profits. Offset against pre-consolidation losses arguably should be allowed only if the group has net taxable income. However, some commentators have argued that “it seems illogical that the right to offset the member’s [pre-consolidation losses] should

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CCCTB WG, 2007), paragraph 22; and European Commission, “CCCTB: possible elements of a technical outline” (CCCTB\WP\057, CCCTB WG, 2007), paragraph 100.

4 In the CCCTB project, the EC experts in general supported this policy: European Commission, “An overview of the main issues that emerged at the second meeting of the subgroup on group taxation” (CCCTB\WP\048, CCCTB WG, 2006), paragraph 10.
be made conditional upon the existence of a positive consolidated taxable income rather than a positive taxable income on the part of each member”.

It is difficult to determine which policy is more logical. The answer may depend on one’s interpretation of the enterprise doctrine and its application at the transition time. Upon consolidation, the doctrine should take over the separate entity doctrine. This implies that the group as a whole should be treated as one single entity. It follows that taxable income and losses of each group member should be treated as belonging to the group as a whole, instead of to individual members. Under this interpretation, it would be logical to require that a company’s taxable income be aggregated with other members’ results before pre-consolidation loss offset can be allowed.

The practical problems of this policy include:

(i) the utilisation of pre-consolidation losses may be delayed, thus increasing the risk of expiry of the losses due to a carry-forward time limit; and

(ii) experience in countries with this policy (for example, the Netherlands and the U.S.) suggests that the rules to allocate a consolidated group’s taxable income to a particular subsidiary are complex.

The alternative policy of giving priority to pre-consolidation losses to offset against a consolidated group’s taxable income may be argued as a grandfather rule. As pre-consolidation losses were incurred when a company is treated as

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Chapter 6 Treatment of Losses

a separate taxpayer under the separate entity doctrine, this status of the company should be grandfathered with respect to the pre-consolidation losses until fully utilised or expired.

This policy has the following advantages:

(i) it is relatively simple to operate; and

(ii) as the pre-consolidation losses have priority of being utilised, the risk of expiry is minimised.

(4) Transfer to parent company:

Under this policy, pre-consolidation losses of a subsidiary are transferred to the parent company upon consolidation. The policy is premised on a strong single entity concept under which consolidated subsidiaries are deemed to have ceased to exist as separate entities for income tax purposes. Instead of cancellation or suspension, their pre-consolidation losses are transferred to the parent company, available to offset against the consolidated group’s taxable income. A major issue with this policy is revenue impact. Unrestricted use of the transferred losses by consolidated groups can have a significant impact on the government’s tax revenue. Complex rules are often required to restrict the use rate of the transferred losses by the consolidated group.

The issue of pre-consolidation losses also arises at leaving time. The question is how those losses – if still remaining at leaving time – should be treated. The answer is straightforward if the losses are quarantined at joining time. Those losses have remained, and will remain, as losses of the subsidiary. The quarantine approach thus applies the enterprise doctrine consistently.
throughout the consolidation cycle, and properly reflects the transitions between the two doctrines at both the joining and leaving time.

The policies of pre-consolidation losses at joining and leaving time in the consolidation regimes of the eight countries are analysed in the next two sections respectively.

6.2.1 Pre-consolidation losses at joining time

Australia

Companies in Australia in general can carry forward losses indefinitely, but no carry back is allowed. 6

Under the strong single entity rule ("SER"), subsidiaries are deemed to have ceased to exist during consolidation. This begs the question of how pre-consolidation losses of subsidiaries should be treated.

The quarantine policy typically restricts the utilisation rate by allowing offset of pre-consolidation losses only against taxable income generated by the same subsidiary. It is the predominant policy adopted by countries with consolidation regimes. 7 However, the government believes that the deemed "disappearance" of subsidiaries under the SER means that the quarantine policy is not an option for Australia, as this option "requires the re-establishment of the identity of the loss entity inside the consolidation group" (emphasis added). 8

6 Section 36-17 ITAA1997.
7 Countries adopting the quarantine policy include France, Italy, the Netherlands, New Zealand, Spain and the U.S.: see discussion of the policy in these countries below.
8 Review of Business Taxation, A Platform for Consultation ("A Platform for Consultation") (1999, AGPS, Canberra), at 563. Out of six options considered by the Review, this option was the only one not adopted in the final recommendation of the Ralph Report: Review of
The extreme deeming provision means that there are three policy options for pre-consolidation losses: (1) the losses are cancelled at joining time;\(^9\) (2) the losses are suspended during consolidation; or (3) the losses are transferred to the parent company.

Australia had an important constraint in the design of its rules on pre-consolidation losses. Before the consolidation regime was introduced in 2002, Australia had a group loss relief regime which in broad terms allowed intragroup loss transfers among resident wholly owned group companies.\(^10\) In other words, wholly-owned groups had been enjoying the benefits of intragroup loss offset. It put pressure on the policy makers to come up with a model that would be at least as attractive as the old group loss relief regime. The pressure was particularly intense as most companies were denied access to the old group loss relief regime after the introduction of the consolidation regime.\(^11\)

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Business Taxation, *A Tax System Redesigned* ("Ralph Report") (1999, AGPS, Canberra), at 524. Ironically, the concept of quarantining pre-grouping losses is not new in Australia. Under the former group loss relief regime, if a company had carry-forward losses when it joined a wholly-owned group, the losses were quarantined and could only be used to offset its own profits: former section 170-30 ITAA1997. This was possible as each group company was still treated as a separate taxpayer, each being required to prepare its stand-alone tax computation. However, under the SER, the government seems to believe that a consolidated subsidiary would not undertake a stand-alone computation anymore. The fact that in practice compensation payments are commonly made between the parent company and its consolidated subsidiaries and are determined based on the latter’s income tax liabilities on a “stand alone” basis suggests that the government’s belief is misplaced.

\(^9\) This option may seem harsh, but is indeed the policy in Japan: Article 81-9(1) Corporations Tax Act. See discussion of the Japanese rule below.

\(^10\) Division 170 ITAA1997. Upon the introduction of the consolidation regime, the scope of the group loss relief regime has been substantially curtailed and now it is applicable only to foreign bank groups with Australian branches and subsidiaries.

\(^11\) The recommendations of the Ralph Review on the loss offsetting rules of consolidation regime were designed to “overcome concerns that groups would be discouraged from consolidating because they could not carry forward … losses [into the consolidated groups]”: A Platform for Consultation, above note 8, at 526. A possible policy to reserve the prevailing
Australia chose the option of allowing transfer of pre-consolidation losses of subsidiaries to the parent company.\textsuperscript{12} The law makes it clear that those transferred losses can be used only if the parent company has taxable income remaining after offsetting against its own losses.\textsuperscript{13} In other words, group losses have priority over pre-consolidation losses.

The parent company is deemed to have made those losses \textit{in the year when the transfer occurs}.\textsuperscript{14} To put the matter beyond doubt, it is deemed that the joining subsidiary “had not made the loss for the income year for which the joining entity actually made the loss”.\textsuperscript{15} The deeming positions are not reversed when the subsidiary leaves the group. Pre-consolidation losses of a

\begin{itemize}
  \item benefits of the group loss relief regime is the grandfather rule. Under this policy, pre-consolidation losses of a subsidiary would be available to offset against profits of wholly-owned group companies as if the old group loss relief regime were still applicable. In this context, the consolidated group could be treated as one single company, implying that the pre-consolidation losses can be utilised to offset against the group’s consolidated profits under the group loss relief regime. It appears that Australia did not consider the grandfather option. Instead, Australia had a temporary “value and loss donor concession” which attempted to address this issue indirectly for groups that consolidated during the transition period (from 1 July 2002 to 30 June 2004): see note 30 below.

\textsuperscript{12} The parent company can use the transferred pre-consolidation losses to offset against its taxable income, subject to loss carry-forward tests. In general, losses of a company can be carried forward indefinitely in Australia, if the majority of voting rights, dividend and capital distribution rights (>50\%) is beneficially owned by the same persons – this is known as the continuity of ownership test (“COT”). If a company fails the COT, it may still be able to carry forward its losses if it satisfies the “same business test” (“SBT”). The general loss carry-forward tests are modified to apply to a consolidated group. For example, if pre-consolidation losses were transferred to the parent company under the modified SBT (known as “SBT losses”), the losses are “refreshed” in the sense that previous ownership changes are ignored in subsequent ownership tests for the parent company. This is an unusually generous policy among the eight countries. However, if the losses were transferred to the parent company under the continuity of ownership test (known as “COT losses”), past ownership changes are still recognised for subsequent tests: section 707-210 ITAA1997.

\textsuperscript{13} Section 707-305(2) & 707-310(3)(b) ITAA1997.

\textsuperscript{14} Section 707-140(1)(a) ITAA1997.

\textsuperscript{15} Section 707-140(1)(b) ITAA1997.
\end{itemize}
subsidary remain with the parent company forever. Among the eight countries, Australia is the only country with this policy of irreversible transfer of pre-consolidation losses to the parent company.

The policy of transferring pre-consolidation losses to a parent company presents a serious problem to the government: unrestricted utilisation of such transferred losses would have significant revenue impact. The solution is an invented concept: the available fraction ("AF").

**AF rules: basic operation and major problems**

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16 The government’s argument for not transferring pre-consolidation losses back to the subsidiary seems to be circular: “an entity that joins as a subsidiary member is taken not to have made the loss”: EM to May 2002 Consolidation Act, paragraph 6.111. The government’s argument is that the losses would not be reverted back to the subsidiary because they had been deemed to be made by the parent company, not the subsidiary. It is puzzling why that deeming position during consolidation should prevent it from being reversed at leaving time. For more detailed discussion of this issue, see Section 6.2.2 below. Similar “no return” policies apply to other tax attributes of a joining subsidiary. For example, a consolidated group maintains only one franking account (which keeps track of the available imputation credits to frank dividends): Subdivision 709-A ITAA1997. Any pre-consolidation credit balance of a subsidiary is transferred to the parent company at joining time, and remains with the group forever even if the subsidiary subsequently leaves the group. An exception to the policy of “parent company keeping tax attributes” is the CFC attribution surplus for CFCs held by a leaving subsidiary: Subdivision 717-E ITAA1997. The surplus is transferred to the leaving subsidiary in order to prevent double taxation of the same income that has already been taxed on an accrual basis under the CFC regime.

17 The government was concerned about the revenue impact of such policy, as it was estimated that there was a “large store of past losses in entities ... approximately $44.6 billion revenue losses and $21.7 billion capital losses”: A Platform for Consultation, above note 8, at 561. To put the numbers into perspective, the taxable income of companies in the 1999-2000 income year was $129 billion: ATO, *Tax Statistics 1999-2000* (available at www.ato.gov.au), accessed on 19 October 2009.

18 Another way to restrict the impact on revenue is to impose additional tests (namely, modified ownership and same business tests) at joining time, attempting to ensure that the joining entity would have been able to use the carried forward losses itself if it had not been consolidated: Subdivision 707-A ITAA1997. Detailed discussion of these tests is beyond the scope of this thesis.
A detailed discussion of the complex AF rules is beyond the scope of this thesis. The major rules and problems of the rules are summarised in the following paragraphs.\(^{19}\)

The underlying design principle of the AF rules is stipulated in the tax law (emphasis added):\(^{20}\)

> the amount of the [pre-consolidation] losses that the [parent company] can utilise is to reflect the amount of the loss that the transferor could have utilised for the income year if the transferor of the loss ... had not become a member of a consolidated group ...

The provision may give an impression that the policy would produce similar results as the quarantine policy, namely the amount of pre-consolidation losses of a subsidiary that the consolidated group may use is equal to the amount of taxable income of that company calculated on a stand-alone basis. However, the actual effect is very different.

The fundamental assumption guiding the design of the AF rules is as follows (emphasis added):\(^{21}\)

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\(^{20}\) Section 707-305(3) ITAA1997. The idea of using “market value” of a company as the proxy for its income-generating capacity originated from the “section 382 loss carryover” rule in the U.S. Detailed discussion of the rule is beyond the scope of this thesis. In broad terms, it would be triggered if there is a majority change (i.e. more than 50%) of share ownership in a company. If so, the amount of loss offset in general is limited to the value of the company at the ownership change time multiplied by a deemed rate of return. For a brief discussion of the rule and the rationale behind the limitation, see Ault & Arnold, above note 2, at 318. Australia is possibly the first country to adopt this idea in the context of consolidation. It is interesting to note that the U.S. did not adopt the idea in its own consolidation regime.

\(^{21}\) Section 707-305(4)(b) & (5) ITAA1997.
a particular transferor’s income ... for the year would have equalled a
fraction of the [group’s] income ... for the year ... The fraction is
worked out by reference to the transferor’s market value at the time of
the transfer (on the assumption that market value reflects capacity to
generate income ... in future).

In other words, for the purpose of restricting the usage rate of pre­
consolidation losses, the AF rules impose a cap equal to a portion of the
group’s consolidated taxable income. The portion is basically determined by
the following ratio at the joining time: 22

\[
\frac{\text{market values of the subsidiary}}{\text{market value of the group}}
\]

This ratio is known as the AF of the bundle of pre-consolidation losses of a
particular subsidiary that is transferred to the parent company. 23 The value of
AF determined at the joining time is not reassessed on a regular basis, even if
the market values of the subsidiary and the group change over time. 24

The AF rules have the following major problems:

(1) Flawed assumption:

22 Section 707-320 ITAA1997. In particular, the market value of the joining subsidiary is
adjusted for (1) items that are deemed to have no income-generating power, namely loss and
franking account balance; and (2) intra-group shareholdings to avoid double counting; section
707-325 ITAA1997 and EM to May 2002 Consolidation Act, paragraphs 8.75 & 8.77. The
market value of the group is adjusted for items in (1) above: section 707-325(1) ITAA1997.

23 For example, if a subsidiary has $100 pre-consolidation loss (with an AF for of 0.5)
transferred to the parent company, and the group has a net taxable income of $60 in an income
year, the parent company can use up to a maximum of $30 (i.e. $60 \times 0.5) of that bundle of
pre-consolidation loss for the year.

24 The value of AF may be adjusted – which would always be downward – if certain specific
events occur, e.g. the consolidated group acquires another loss subsidiary, or the consolidated
group is acquired by another group: section 707-320(2) ITAA1997.
The underlying assumption of the AF rules is that “market value reflects capacity to generate income or gains in future”.\(^\text{25}\) This is a highly questionable assumption. Market value does not necessarily reflect income-generating power. The market value of a company (for example, in financial crisis) may simply reflect the realisable values of assets in case of liquidation.

A proxy should not be used if a more precise measure is readily available. Experience in most other countries strongly suggests that a much more precise measure is indeed available: the actual taxable income generated by the subsidiary during consolidation.

(2) “Outdated” value of AF:
The value of AF attached to pre-consolidation losses of a subsidiary is determined at its joining time, based on the prevailing market values of the company and the group. The value is not updated regularly to reflect changes in market values of the company and group over time. It follows that in most cases the AF rules fail to achieve the objective of reflecting the loss that a subsidiary could have utilised if it had not joined the consolidated group. The resulting limit of use rate is therefore arbitrary. One may argue that compliance costs would be too high if regular revaluation of group members is required. However, without such exercise, the values of AFs may become more irrelevant over time and more detached from the actual income-generating capacity of each group member.

(3) A game of arithmetic:
The sum of AFs of all loss bundles in a group can not be more than one. Otherwise, the total amount of offset of transferred losses that could be used in

\(^{25}\) Section 707-305(5) ITAA1997.
a year would be more than the amount of group’s taxable income. Therefore, the law stipulates specific adjustments of AFs under certain circumstances to ensure that the sum of all AFs in a group is not more than one.

It is interesting to note that all adjustment events will never adjust an AF upwards. This is so even if a particular subsidiary has turned around and makes substantial profits. The adjustments become mechanical rules and a game of arithmetic to ensure that the sum of AFs is not more than one, deviating from the original design principle.

(4) Complexity
Market valuations are inherently uncertain and prone to manipulations. Both compliance and policing costs are high. Anti-avoidance rules are required to deal with arrangements attempting to manipulate the AF values.

AF: a good choice?
The Australian government claims that the objective of the AF rules is to reflect the loss use rate if the subsidiary has not joined the consolidated group. With the questionable use of “market value” as a proxy for the actual tax positions of a company, and the failure to adjust the market valuations on a regular basis, the AF rules fail to achieve the objective.

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26 This is clearly the intention of the Australian government, which states that an “adjustment event can never result in an increased available fraction”: EM to May 2002 Consolidation Act, paragraph 8.53.


28 It is interesting to note that the AF concept was never considered in the consultation process of the consolidation regime. The Ralph Committee had considered six options to deal with the pre-consolidation loss issue: A Platform for Consultation, above note 8, at 561-564. The final recommendation of the Ralph Committee was a mixture of most of the options: Ralph Report, at 524. In essence, it recommended that all pre-consolidation losses could be rolled
However, if one accepts that the most important objective of the AF rules is to restrict the use rate of pre-consolidation losses, the mechanical AF calculations seem to serve that purpose well. This is especially so given that the AFs of a group can only be adjusted downwards under all adjustment events.

It may be more accurate to describe the AF rules as simply a rough measure to allocate a group’s taxable income to individual group members for the purpose of controlling the use rates of pre-consolidation losses.

Ironically, another advantage of the AF rules is a result of its arbitrariness. In comparison with the models in other countries, specific anti-avoidance provisions are not required in Australia to prevent abuse of loss offset rules by intra-group asset transfers. For instance, specific anti-avoidance provisions are required in Italy and the Netherlands to prevent accelerating utilisation of pre-consolidation losses of a company by intra-group transfer of assets with hidden reserves.29 This kind of provision is not necessary under the AF model, as the utilisation rate is not dependent on a subsidiary’s individual taxable income.

over into the group, subject to a limit of the use rate for certain losses. In broad terms, except for pre-consolidation losses attributable to the group’s ownership, other losses in general would be brought into the group over a 5-year period: ibid, Recommendation 15.3. The government did not adopt the recommendation of the Ralph Report. No clear reason was given except the following paragraph (emphasis added): “The available fraction method departs from Recommendation 15.3 of A Tax System Redesigned. It was developed in consultation with interested taxpayers and their advisers after earlier consultations concluded that the method contained in Recommendation 15.3 would be inequitable in certain circumstances”: EM to May 2002 Consolidation Act, paragraph 8.4. The government did not elaborate what circumstances would lead to inequitable outcomes.

29 Article 123(2) Testo unico delle imposte sui redditi (Income Tax Code of Italy); and Article 15ae(2) Wet op de vennootschapsbelasting 1969 (Corporate Income Tax Law of the Netherlands).
Chapter 6 Treatment of Losses

It is doubtful if this advantage is sufficient to justify the problematic AF rules, which are detached from the actual circumstances of a company. The AF rules would still apply regardless of whether or not there has been any intra-group transfer of assets with hidden reserves. With this “presumed guilty” effect, one may argue that the AF rules are not fair to all taxpayers.

Corporate groups seem to be content to play the AF game, despite the problematic rules. If a group can generally claim pre-consolidation losses at a reasonable rate, it may not have much incentive to complain. The flexibility in the market valuation process may also provide some room to manoeuvre.\textsuperscript{30}

\textit{France}

In general, losses incurred by a company in France can be carried forward indefinitely, and a company can elect to carry back losses for three years.\textsuperscript{31}

Pre-consolidation losses incurred by a company are quarantined and can only be used to offset against profits generated by that company.\textsuperscript{32} As the French consolidation regime is a pooling system, the group’s taxable income or losses

\textsuperscript{30} The potential pain imposed by the AF rules was reduced by specific concessions during the transitional period. In broad terms, there were two concessions available to groups that consolidated during the transitional period (from 1 July 2002 to 30 June 2004): (1) value and loss donor concession: a joining subsidiary might include market value and losses from another joining subsidiary for the purposes of the AF rules; and (2) certain pre-consolidation losses might be amortised over 3 years, instead of subject to the AF rules: section 707-325 & 707-350 Income Tax (Transitional Provisions) Act 1997. For a detailed explanation of the concessions, see EM to May 2002 Consolidation Act, Chapter 9. In practice, it was possible to make use of the value and loss donor concession to put all losses and values in one company, thus achieving an AF of 1 for the bundle of transferred losses from that company. However, groups that consolidate after the transitional period are not eligible for the generous concession. As the concessions were no longer available to groups that consolidate after 30 June 2004, they are not discussed in detail in this thesis.

\textsuperscript{31} Articles 209 & 220 quinquies CGI.

\textsuperscript{32} Article 2231 CGI.
are determined as the algebraic sum of each group member’s taxable income or losses.\textsuperscript{33} It follows that the pre-consolidation losses are applied to offset against a company’s taxable income before any net amount is pooled together at the parent company level.

The policy of quarantining pre-consolidation losses together with the priority of applying the company’s future taxable income against these losses has the advantage of simplicity. If the company’s future taxable income are contributed to the group’s taxable income first, the pre-consolidation losses are usable only when the group has overall net taxable income. In that case, complex rules are required to apportion the group’s consolidated taxable income to determine how much taxable income should be available to offset against the pre-consolidation losses.\textsuperscript{34}

The quarantine policy may be subject to abuse. For example, a group may manipulate intra-group transactions to create more profits for a subsidiary with pre-consolidation losses. Specific anti-avoidance provisions are in general required to prevent abuse of the quarantine policy. In the absence of such provisions, it may be possible to accelerate the utilisation of pre-consolidation losses of a company if assets with hidden reserves are transferred to it from other group companies (which would be tax free under consolidation). Gains realised on disposal of the asset by the company would be offset by the pre-consolidation losses, thus accelerating the utilisation of the losses. In other words, the anti-avoidance provision aims to ensure that offset of pre-consolidation losses of a company is allowed only to the extent of future

\textsuperscript{33} Article 223B CGI.

\textsuperscript{34} See discussions of the rules in the Netherlands, Spain and the U.S. in this section.
profits generated by the *same enterprise* being carried on by the company immediately before the joining time.

France has a number of anti-avoidance provisions dealing with this issue. For instance, pre-consolidation losses can not be used to offset against profits generated by debt forgiveness by a consolidated group member, or capital gain on disposal of assets to another group member.  

**Italy**

In general, losses of a company may be carried forward for five years, except losses incurred in the first three years of operation (to which no time limit applies); no carry-back is allowed.  

Similar to France, pre-consolidation losses of a company joining a consolidated group are quarantined. They can be used to offset only future taxable income of that company. If the company has a net taxable income after offsetting the pre-consolidation losses, that net amount is then pooled together with the results of other group members to arrive at the group’s consolidated taxable income or loss.  

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36 Article 84 TUIR.


38 Article 118(1) TUIR. For an example of how the rules work, see Example 10 in Leone & Zanotti, ibid, at 192.
The “quarantine plus priority over group loss” policy has the advantage of minimising the risk of expiry of those losses, as company losses in Italy can be carried forward to a maximum of 5 years.

Similar to France, Italy has a specific anti-avoidance provision to deny offset of pre-consolidation losses of a company against gains realised on assets transferred from another group member. 39

**Japan**

In general, companies can carry forward losses for seven years. 40 The tax law provides for carry-back of losses; however, the provision has been suspended for most companies since 1 April 1992. 41

Japan has the most stringent rule on pre-consolidation losses of a joining subsidiary: the losses are in general extinguished at the joining time. 42 Parent company’s pre-consolidation losses are not subject to this harsh treatment. They can be carried forward and offset against the group’s taxable income. The rationale for this more lenient treatment for the parent company is “the

39 Article 123(2) TUIR.

40 Article 57 CTA.


42 Article 81-9(1) CTA. The author is indebted to Yoshihiro Masui for clarification of Japan’s rules on pre-consolidation losses. The cancellation rule is subject to a limited number of exceptions, e.g. losses incurred due to disasters: Article 81-9(2)(i) CTA. See also Fumihiro Komamiya, “Branch Report: Japan” in International Fiscal Association, *Cahiers de Droit Fiscal International Volume 89b: Group Taxation* (2004), at 398; KPMG, “Taxation in Japan 2008” (available at www.kmpg.or.jp), accessed on 11 February 2009, paragraph 1.11; and IBFD, “Country Analyses - Japan - Corporate Taxation (online database)” (available at www.ibfd.org), accessed on 28 December 2010, paragraph A.8.2. This harsh cancellation rule has been relaxed since 1 April 2010: see discussion below.
unlikelyhood of tax avoidance”.\textsuperscript{43} It implies that anti-avoidance may be the primary reason for the policy on pre-consolidation losses of subsidiaries.

The cancellation of pre-consolidation losses of joining subsidiaries is a major disincentive for corporate groups in Japan to elect for consolidation. It seems that the government has not been too enthusiastic about the introduction of the consolidation regime. Other policies that also suggest such an attitude include: deemed disposal of certain assets at market value at joining time,\textsuperscript{44} and the two per cent consolidation surcharge in addition to the normal corporate tax rate (imposed for the first 2 years of the introduction of the consolidation regime in 2002).\textsuperscript{45} These policies may have contributed to the relatively small number of groups that have elected to consolidate so far.

The cancellation policy is simple, avoiding complex rules to restrict the use rate of pre-consolidation losses if they are allowed to be transferred to the group. However, it violates the principle of neutrality. The tax outcome of a company with carried forward losses would be very different depending on whether it joins a consolidated group or not.

The treatment of pre-consolidation losses has been relaxed under the 2010 tax reform in Japan.\textsuperscript{46} Effective 1 April 2010, pre-consolidation losses of a joining subsidiary can be used to offset against its own taxable income after

\textsuperscript{43} Komamiya, ibid, at 398.

\textsuperscript{44} For more detail of this policy, see Chapter 7 Section 7.3.

\textsuperscript{45} Darcy, above note 41, at 245.

\textsuperscript{46} In 2009, the Japanese government proposed to relax the cancellation policy and consider the quarantine policy under which the pre-consolidation loss of a subsidiary can be used to offset against the company’s future taxable income: IBFD, “Tax reform proposals for 2010” (dated 29 December 2009) TNS Online at 20 July 2010; and Edwin T Whatley et al, “Japanese Government Announces 2010 Tax Proposals” (29 December 2009) Tax Analysts - Worldwide Tax Daily (available at www.taxanalysts.com), accessed on 23 July 2010.
consolidation, provided, among other things, the subsidiary has been wholly-owned by the parent company for five years before the joining time.47

The Netherlands

In general, losses can be carried back one year and carried forward nine years in the Netherlands.48

Pre-consolidation losses incurred by a group member in a fiscal unity can only be offset against group profits to the extent that those profits are attributable to the company on a fictitious stand-alone basis.49 In other words, pre-consolidation losses are effectively quarantined.

Different from France and Italy, the offset of pre-consolidation loss is possible only if the consolidated group as a whole has net taxable income for the year. In other words, losses of group members generated during consolidation have priority over pre-consolidation losses. This reflects a more faithful application of the enterprise doctrine. For example, taxable income generated by a subsidiary during consolidation is treated as taxable income generated by the fiscal unity. It is not available to offset against pre-consolidation losses incurred by the subsidiary, unless the consolidated group as a whole has net taxable income.


48 Article 20 Vpb. The time limits were more lenient before 1 January 2007, namely carry-back for 3 years and carry-forward indefinitely: IBFD, “Country Analyses - The Netherlands - Corporate Taxation (online database)” (available at www.ibfd.org), accessed on 20 July 2010, paragraph 2.11.1.

49 Articles 15ae(1)(a) & 15ah Vpb. Carry-back of group losses to offset against pre-consolidation profits of a particular group member is subject to similar rules: Article 15ae(1)(b) Vpb.
The disadvantage of this policy is complexity. The computation of the portion of the group’s taxable income attributable to a particular group member is subject to a set of complex “profit-split” rules.\textsuperscript{50} Two main objectives guide the design of the rules:\textsuperscript{51}

(i) to prevent offset of pre-consolidation losses of a company against profits generated by other group members during consolidation; and

(ii) to treat the fiscal unity as one single taxpayer without hindering loss offsets among its group members.

The resulting rules are so complex that in practice the attribution of the consolidated group’s taxable income are sometimes determined by negotiation with the tax authorities.\textsuperscript{52} The attribution rules also invite back transfer pricing issues, as the taxable income attributable to a particular subsidiary has to be computed on a deemed stand-alone basis.\textsuperscript{53}

Similar to France and Italy, anti-avoidance rules exist to prevent accelerating the use of pre-consolidation losses by intra-group asset transfer.\textsuperscript{54} In


\textsuperscript{51} Ibid.

\textsuperscript{52} Vries, above note 50, at 474.


\textsuperscript{54} Article 15ae(2) Vpb.
particular, such offset would be denied unless the hidden reserve has already been taxed under the deemed sale rule for intra-group transferred assets.\textsuperscript{55}

\textit{New Zealand}

In general, a company in New Zealand can carry forward losses indefinitely; no carry-back is allowed.\textsuperscript{56}

New Zealand faced similar pressure as Australia in the policy design for pre-consolidation losses of a joining subsidiary. A group loss relief regime has been in place before the introduction of its consolidation regime.\textsuperscript{57} Therefore the loss offset benefits being enjoyed under the group loss relief regime had to be preserved in order to make the consolidation regime attractive.

In contrast to Australia, New Zealand decided to have both regimes coexist, allowing companies to utilise their losses under both consolidation and group loss relief regimes. A consolidated group in general is treated as one single company. Therefore, loss transfers are generally allowed between a company and a consolidated group, or even between two consolidated groups, under the group loss relief rules.\textsuperscript{58}

It is interesting to compare the policies in Australia and New Zealand at this point. Both countries faced similar pressure from the existing group loss relief regime, while attempting to apply the enterprise doctrine under the consolidation regime. Australia chose to deny the group loss relief regime

\textsuperscript{55} Article 15ai(1) Vpb. For a discussion of the specific anti-avoidance rule, see Chapter 7 Section 7.2.

\textsuperscript{56} Section IA 3 ITA2007.

\textsuperscript{57} The group loss relief regime in general requires common voting interests of at least 66\% held by ultimate individual persons: section IC 3 ITA2007.

\textsuperscript{58} Gareth Harris et al, \textit{Income Tax in New Zealand} (2004, Brookers, Wellington), at 964.
from most companies upon the introduction of the consolidation regime, thus effectively forcing corporate groups to elect to consolidate. New Zealand took a different path, allowing both regimes to coexist.

The Australian approach is simpler in the sense that one regime, instead of two, is applicable to a group. The price for that simplicity is the problematic and complex AF rules. The policy choice may reflect a more “anti-avoidance” flavour, as the government tried to herd corporate groups into the consolidation regime which is regarded primarily as an anti-avoidance regime.\textsuperscript{59}

In contrast, the New Zealand approach is more flexible and taxpayer-friendly. The policy choice reflects the government’s attitude that the consolidation regime is primarily a measure to recognise the economic substance of a group and to pursue the policy objective of competitiveness.

Pre-consolidation losses of a subsidiary are quarantined and remain with the company. Those losses can be used to offset against its consolidated group’s taxable income, subject to the limit of:\textsuperscript{60}

\begin{itemize}
  \item (i) its own taxable income for the tax year “if it were not in the tax year part of a consolidated group”; and
\end{itemize}

\textsuperscript{59} It has been observed that the consolidation regime “is at base an integrity measure, designed to stop taxpayers exploiting mismatches”: Geoffrey Lehmann, “An Assessment of Australia’s Tax Consolidation Regime” in Geoffrey Lehmann (ed), \textit{Business Tax Reform - Meet the Critics}, Australian Tax Research Foundation Conference Series (2007, Australian Tax Research Foundation, Sydney), at 265. In addition, one of the objectives of the consolidation regime is to “prevent a double tax benefit ... from an economic loss realised by a consolidated group”: section 700-10(b) ITAA1997. However, its effectiveness as an anti-avoidance measure is questionable. See the discussion of this issue in Chapter 4 Section 4.2.

\textsuperscript{60} Section ID 2(2) & 3 ITA2007.
(ii) taxable income of other group companies that would satisfy the group loss relief rules. For instance, the losses had to be incurred when the companies involved had a common voting interest of at least 66 per cent.

If there are any remaining pre-consolidation losses after offsetting against group profits, those losses may be used to offset against profits of another company or consolidated group under the group loss relief rules.  

In the absence of a general capital gains tax, intra-group transfer of assets with hidden reserves is in general a non-issue for loss offset rules in New Zealand.  

Spain

In general, losses of a company can be carried forward for fifteen years in Spain; no carry back is allowed.  

Pre-consolidation losses of a company may be offset against the taxable income of the consolidated group, subject to the limit of stand-alone taxable income of that company. The rules were basically imported from the U.S. (known as "separate return limitation year" or SRLY rules) in 1977 to prevent

61 Section ID 2(3) ITA2007.  
63 Section 25(1) LIS. For newly established company, the 15-year period starts from the first profit-making year: Section 25(3) LIS. The carry forward time limits had been increasing over the years: the limits were 7 years in 1995, increased to 10 years in 1998, and increased again to 15 in 2001: Ruiz, above note 5, at 621.  
64 Section 74(2) LIS.
acquisition of loss companies into a consolidated group solely for the purpose of using the losses.\textsuperscript{65} The offset is allowed only if the group has a net taxable income after offsetting against the group’s own carry-forward losses (if any).\textsuperscript{66}

**The United States**

In general, companies in the U.S. can carry forward losses for twenty years and carry back for two years.\textsuperscript{67}

The consolidation regime in the U.S. recognises the transition between the two doctrines at joining time in the form of its “separate return limitation year” (“SRLY”) rules. Basically, the policy is to quarantine the losses to the subsidiary and allow offset against its own taxable income generated during consolidation.\textsuperscript{68} The rationale behind the policy is the belief that it is inappropriate to apply the enterprise doctrine to losses incurred in years when a company is taxed as a separate taxpayer.\textsuperscript{69} This is in contrast to the Australian approach under which pre-consolidation losses are transferred to the parent company and are deemed to have been incurred by the parent company at the transfer time.

\textsuperscript{65} Ruiz, above note 5, at 622. Since 2002, intra-group dividends are excluded from the stand-alone taxable profits that can be offset against pre-consolidation loss of a company: José Ignacio García Muniozguren, “Spain: New Corporate Tax Measures for 2002” (2002) 42(3) European Taxation 138, at 139-140.

\textsuperscript{66} Section 71(1) LIS. The ordering of loss offset was amended in 2001, making the offset more difficult in practice: Ruiz, above note 5, at 618.

\textsuperscript{67} IRC Section 172.

\textsuperscript{68} As losses may be carried back in the US, the SRLY rules also apply to carry back of losses of ex-subsidiary: Reg. 1.1502-21(c)(1)(i). However, the carry-back is possible only if the ex-subsidiary has a net positive contribution to the group’s taxable income during consolidation: see Reg. 1.1502-21(c)(1)(iii) Example 3.

SRLY rules: basic operation

In broad terms, under the SRLY rules, pre-consolidation losses of a subsidiary can be used to offset against the consolidated group’s taxable income, to the extent of the subsidiary’s net taxable income generated during consolidation.\(^{70}\)

For example, assume that Company S with $100 carried-forward loss joins a consolidated group at the beginning of the year, and the group has $300 consolidated taxable income for the year (with $70 taxable income being attributable to S’s income and deductions).\(^{71}\) The SRLY limitation for the year would be $70. Therefore, out of the $100 pre-consolidation losses, $70 can be offset against the group taxable income.

The parent company is not subject to the SRLY rules.\(^{72}\) In general, losses carried forward or backward to a consolidated group are applied in the order

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\(^{70}\) Reg. 1.1502-21(c)(1)(i).

\(^{71}\) This example is based on Example 1 in Reg. 1.1502-2(c)(1)(iii).

\(^{72}\) Reg. 1.1502-1(f)(2)(i). Another major exception to the SRLY rules applies if a company joins a consolidated group within 6 months of ownership change that has triggered the general anti-loss trafficking rules in section 382 of IRC: Reg. 1.1502-21(g)(2)(ii). This is known as the “overlap rule”, under which only section 382 rules would apply. For example, if a consolidated group acquires 100% of a loss company which joins the consolidation at the same time, section 382 instead of the SRLY rules would apply. Detailed discussion of the section 382 rules is outside the scope of this thesis. In broad terms, the rules would be trigger if there is a share ownership change of more than 50%. If so, subject to other requirements (such as the same business test), the amount of loss offset is limited to the value of the company at the ownership change time multiplied by a deemed rate of return. For a brief discussion of the rules and the rationale behind the limitation, see Ault & Arnold, above note 2, at 393-394. The interaction between section 382 and the SRLY rules can be complex. For example, in some circumstances, neither rule applies; but in other circumstances, both limitations apply: see Reg. 1.1502-21(g)(5) Examples 2 & 3. See also discussion of their interaction in Kevin M Hennessey et al, *The Consolidated Tax Return: Principles, Practice & Planning* (2003), at 8.05[6]. Pre-consolidation losses are also subject to a “myriad” of other limitations and rules, detailed discussion of which is again outside the scope of the thesis. For a list of these rules, see Hennessey, ibid, at 8.08.

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of the tax years in which they were incurred. Losses incurred in the same year are applied on a pro-rata basis.\footnote{Reg. 1.1502-21(b)(1).}

If a consolidated group with accumulated losses joins another consolidated group, those group losses are subject to the SRLY rules as if they are losses incurred by one single company. In other words, the SRLY limitation applies to those losses on a “subgroup” basis.\footnote{Reg. 1.1502-21(c)(2).}

The SRLY rules also apply to unrealised losses at joining time (known as “built-in losses” in the U.S.), if the loss is realised within five years.\footnote{Reg. 1.1502-15.}

The SRLY rules have a built-in mechanism to prevent abuse of accelerating utilisation of pre-consolidation losses by intra-group transfer of assets. In the computation of a subsidiary’s taxable income generated during consolidation (for the purposes of the SRLY limitations), deferred gain or loss on intra-group transfer of asset is not taken into account.\footnote{In particular, the SRLY limitation in general is defined to be “the aggregate consolidated taxable income for all consolidated return years of the group determined by reference to only the member’s items of income, gain, deduction, and loss” (emphasis added): Reg.1.1502-21(c)(1)(i). In other words, the company’s taxable income is computed under consolidation rules, thus ignoring intra-group asset transfers. See also Hennessey, above note 72, paragraph 8.05.} Therefore, such transfer would not accelerate the utilisation rate of pre-consolidation losses. In addition, there are complex anti-avoidance loss disallowance rules for consolidated groups in the U.S.\footnote{Detailed discussion of the rules is beyond the scope of this thesis. For a discussion of the rules, see for example Hennessey, ibid, Chapter 14.}
Chapter 6 Treatment of Losses

The ability to carry back losses in the U.S. gives rise to a problem that is the mirror-image of the pre-consolidation losses issue. For instance, if a consolidated group acquires a new subsidiary in Year 1 and the latter incurred losses that year, potentially the “post-consolidation losses” may be carried back to offset group profits before Year 1. This possibility is now dealt with by the SRLY rules.\(^{78}\)

**Comparison with the Australian policy**

The underlying objective of the SRLY rules is that the rules “should neither augment nor limit [the company’s] ability to use its own loss”.\(^ {79}\) It leads to a regime under which a subsidiary maintains to a relatively large extent its separate entity status during consolidation.

It is interesting to note that Australia also claims to have a similar objective for its AF rules, namely the rules should “reflect the amount of the loss that the [subsidiary] could have utilised ... if the [company] had not become a member of a consolidated group ...”.\(^ {80}\) However, as discussed above in the section on Australia, the actual effect is quite different. The Australian policy uses the historical market value of the subsidiary at joining time as a proxy for the income-generating capacity of the company in future. In contrast, the U.S. determines the amount of losses available for offset by computing a subsidiary’s stand-alone taxable income during consolidation.

\(^{78}\) In particular, as long as a loss can be carried to a separate return year (no matter whether it is carried forward or backward), the SRLY rules in general apply: Reg.1.1502-21(b)(2). See also discussion of the issues in Hennessy, ibid, paragraph 8.03[1].

\(^{79}\) Sparagna, above note 69, at 718.

\(^{80}\) Section 707-305(3) ITAA1997.
The Australian model suffers from the use of an outdated proxy, not adjusted regularly to reflect the changing circumstances of the subsidiary. In contrast, the U.S. model is based on more precise and relatively more reliable data.

The comparison between the two countries is particularly interesting as the Australian AF concept was originated from the "section 382 loss carryover" rule in the U.S.\textsuperscript{81} It is telling that the U.S. did not adopt a similar loss limitation rule (that is, based on market value of a group company) for its consolidation regime.

\textit{Comparison with the Dutch policy}

Compared to the U.S. rules on pre-consolidation losses, the Dutch rules subtly demonstrate a stronger influence of the enterprise doctrine. While the U.S. would allow offset of such losses only if \textit{a company on a deemed stand-alone basis} generates net taxable income during consolidation, the Netherlands would so allow if \textit{the group as a whole} generates net taxable income.

For example, assume that Company A has a pre-consolidation loss of $100, and after consolidation, a loss of $120 in Year 1 and a profit of $100 in Year 2. Also assume that the parent company P has a profit of $80 in Year 1 and a profit of $120 in Year 2.\textsuperscript{82} The data is summarised in Table 6:

\textsuperscript{81} See note 20 above.

\textsuperscript{82} This example is based on the example of pre-consolidation loss offset in Müller, above note 50, at 267.
Table 6 Treatment of pre-consolidation losses in the Netherlands and the United States

<table>
<thead>
<tr>
<th>Year</th>
<th>A</th>
<th>P</th>
<th>Group</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>($120)</td>
<td>$80</td>
<td>($40)</td>
</tr>
<tr>
<td>2</td>
<td>$100</td>
<td>$120</td>
<td>$220</td>
</tr>
<tr>
<td>Total</td>
<td>($20)</td>
<td>$200</td>
<td>$180</td>
</tr>
</tbody>
</table>

Under the U.S. rules, Company A would not be able to use its pre-consolidation losses in Year 2 as it would have a net loss of $20 during consolidation on a stand-alone basis. However, under the Dutch rules, the group as a whole makes a net profit of $180 in Year 2. This is enough to trigger the attribution rules to allocate the group profits to Company A. As losses are generally applied in chronological order, Company A’s pre-consolidation loss of $100 would be fully utilised in Year 2.

The Dutch policy has the advantage of accelerating the use rate of pre-consolidation losses, thus reducing the risk of expiry of those losses under the carry-forward time limit.

6.2.2 Pre-consolidation losses at leaving time

Australia

As discussed above, pre-consolidation losses of a subsidiary transferred to the parent company in a consolidated group are deemed to have been incurred by the latter at joining time.\(^8\) The deeming provision is not reversed when the

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\(^8\) Section 707-140 ITAA1997.
subsidary leaves the group. The pre-consolidation losses stay with the parent company. This policy is unique among the eight countries.

It is doubtful if the policy of the parent company keeping pre-consolidation losses of a subsidiary reflects properly the transition between the two doctrines. One may argue that at leaving time the deeming provisions should be reversed to reflect the transition from the enterprise doctrine back to the separate entity doctrine. The pre-consolidation losses should revert to the subsidiary that had originally incurred the losses.

The government's argument for not reverting the pre-consolidation losses to the subsidiary is that "an entity that joins as a subsidiary member is taken not to have made the loss". It is unclear if the logic of the argument can stand. Basically, the government argued that the losses would not revert to the subsidiary because they had been deemed to be made by the parent company, not the subsidiary. However, that deeming position during consolidation should not prevent the deemed position from being reversed at the leaving time. A more plausible rationale for the policy is that during consolidation, assets can be transferred tax free between group members without any tracking of asset movement or recapture of deferred gain when either the transferor or transferee leaves the consolidated group. The government believes that a leaving subsidiary should be regarded as a different entity for income tax purposes from the one at joining time, despite both in fact being the same legal entity. It is therefore inappropriate to revert the pre-consolidation losses to the leaving subsidiary.

84 EM to May 2002 Consolidation Act, paragraph 6.111.
85 For more detailed discussion of the Australian policies on assets, see Chapter 7 Section 7.2.
86 Board of Taxation, Post-implementation Review into Certain Aspects of the Consolidation Regime: Discussion Paper (2009), paragraph 2.3.
An advantage of the policy of keeping pre-consolidation losses in the parent company is simplicity. If pre-consolidation losses revert to the subsidiary, anti-avoidance provisions would be required to prevent abuse such as transferring assets with hidden reserves to the company before it leaves the group. Otherwise, the company would be able to accelerate utilisation of the pre-consolidation losses.\textsuperscript{87} However, it is doubtful if simplicity is a sufficient justification to deny the leaving subsidiary from getting back its pre-consolidation losses, especially if there is no intra-group transfer of assets with hidden reserves to the company during consolidation.

Another problem of the policy of "pre-consolidation losses staying with parent company" is that utilisation of those losses is still subject to the AF rules. As the AF for the loss bundle is supposed to reflect the relative income-generating capacity of the subsidiary in the group, it is doubtful if the AF should still be relevant when the subsidiary is no longer with the group.\textsuperscript{88}

\textsuperscript{87} For an example of such anti-avoidance provisions, see the discussion of the rules in the Netherlands in Section 6.2.1 above.

\textsuperscript{88} The government's argument on this policy is again questionable. Its argument is as follows (emphasis added): "While a loss entity that leaves a group ceases to contribute income to the group, the cash or assets received by the group on the sale of the loss entity continue to generate income for the group, leaving the group's income generating capacity unchanged": EM to May 2002 Consolidation Act, paragraph 8.20. The argument fails to recognise that the income-generating capacity of a company changes over time. Even if it is accepted that the market value of a company reflects its income-generating capacity, the market value of the subsidiary would most likely be different between the joining and leaving time. This is especially possible given that assets can be transferred freely within a consolidated group. Using the historical AF -- which was determined at the joining time -- after leaving time is therefore inappropriate.
France

Under the quarantine policy, pre-consolidation losses stay with the company throughout the consolidation cycle, and remain with it after the company leaves the consolidated group.

In France, a company in general can elect to carry back losses for three years. A similar quarantine concept applies to post-consolidation losses. Losses incurred by a company after leaving a consolidated group are not allowed to be carried back to offset against prior years' group taxable income. In this respect, the French consolidation rules properly apply the enterprise doctrine, under which a consolidated group's taxable income is treated as generated by the group as a whole, instead of by individual group members.

Italy, the Netherlands, New Zealand, Spain and the United States

Similar to France, pre-consolidation losses in these five countries always stay with the company under the quarantine policy throughout the consolidation cycle, and also after consolidation.

Japan

As discussed above, pre-consolidation losses of a subsidiary in general are effectively cancelled at joining time in Japan. They are lost forever, even after the subsidiary leaves the consolidated group. This policy is harsh when compared to the other seven countries. It is also biased against a company that joins a consolidated group to another company that does not consolidate.

89 Article 223K CGI.
90 Article 57(9)(iii) CTA.
6.3 Group losses

During consolidation, the enterprise doctrine applies and a consolidated group is treated as one single taxable unit. It follows that the overall net loss of a consolidated group incurred during consolidation should belong to the group as a whole, instead of to individual members. It is therefore reasonable to quarantine the loss to the consolidated group, instead of allocating it to individual group members.

At leaving time, group losses pose a similar transition problem as pre-consolidation losses, but in a “reverse” sense: the issue is how group losses — generated under the enterprise doctrine — should be treated when a subsidiary leaves a consolidated group when the separate entity doctrine applies again. Under the enterprise doctrine, group losses are treated as those incurred by the enterprise as a whole. Consistent with the quarantine policy adopted for group losses incurred during consolidation, those losses should remain with the group when a subsidiary leaves. However, the analysis below shows that this policy is not always adopted in the eight countries.

De-consolidation occurs when a consolidated group ceases to be consolidated and all group members become separate taxable units again. It poses the difficult question of whether group losses should be shared out among group members, stay with the parent company, or be cancelled all together.

The enterprise doctrine does not provide a clear answer. It is possible to argue that if group losses are treated as incurred by a consolidated group as a whole under the enterprise doctrine, the losses should be cancelled at de-consolidation as the taxpayer (namely the consolidated group) no longer exists. However, this option is unlikely to be to be acceptable by most taxpayers.
Other possible policies include:

(a) Stay with parent company:
Under this alternative, accumulated group losses generated during consolidation stay with the parent company as the surviving member of the consolidated group. This policy applies the enterprise doctrine in the sense that as a consolidated group is regarded as an enterprise controlled by the parent company, the group losses should stay with the parent company as the heir for the group.

The advantage of this policy is simplicity, as compared to the "share out" policy below.

(b) Share out:
An alternative policy is to share out the accumulated losses among group members. This policy arguably reflects properly the transition between the two doctrines. During consolidation, taxable income and losses of group members are combined to arrive at the group's net tax loss under the enterprise doctrine. When the doctrine ceases to apply at deconsolidation, the tax attributes of the group, including group losses, should be distributed back to individual group members.

The share-out policy leads to the difficult question of how the losses should be shared among group members. Should the losses be traced back to each group member that has contributed to the group loss, or should the losses be shared among group members at the deconsolidation time? A strict application of the enterprise doctrine would tend to support the latter policy, as group losses should not be
attributable to individual group members when they are incurred. This policy also has the advantage of avoiding tracing losses through multiple years.

Another interesting issue that arises when a consolidated group with accumulated group losses is acquired by another consolidated group is how the accumulated losses of the first group should be treated. Similar to the analysis of pre-consolidation losses under normal joining circumstances, in theory those losses should be quarantined under the enterprise doctrine. This represents the proper application of the enterprise doctrine, namely, the group is treated as one single entity under consolidation and thus its accumulated losses should be treated in the same way as normal pre-consolidation losses of a subsidiary.

The policies on group losses during consolidation, at leaving time and at de-consolidation in the eight countries are analysed in the following three sections respectively.

6.3.1 Group losses during consolidation

Australia

Under the strong single entity rule in Australia, all subsidiary members are treated as parts of the parent company.\(^9^1\) During consolidation, the whole consolidated group is treated as just one single company: the parent company. It follows that group losses generated during consolidation are treated as losses generated solely by the parent company.

\(^9^1\) Section 701-1 ITAA1997.
Chapter 6 Treatment of Losses

France

A consolidated group has a net loss if the algebraic sum of taxable income and losses of its group members is negative. The group can carry forward the losses indefinitely to offset against future consolidated taxable income, or can elect to carry back the losses for three years.

The tax law stipulates that tax losses incurred by a subsidiary member during consolidation that are taken into account in the computation of the group’s taxable income or loss are no longer available to the subsidiary. In effect, those losses are treated as having been transferred to the parent company.

Italy

Under the pooling system, taxable income and losses of group members are aggregated together to calculate the group’s overall taxable income or loss. Group losses can be carried forward by the parent company, subject to the general carry-forward time limit.

The Italian tax law is flexible in the order of application of losses incurred by group members. The parent company is free to decide which member’s loss to be used in a particular year. For example, if a parent company with a taxable income of $100 has two consolidated subsidiaries A and B, each subsidiary

92 Article 223B CGI.
93 Article 223C CGI.
94 Article 223G CGI.
95 Article 223E CGI.
97 Article 118(1) TUIR.
98 Article 118(1) TUIR.
with a loss of $100, the parent company can decide to use either of the following losses to offset against its profits:

(1) A's $100 loss;  
(2) B's $100 loss; or  
(3) portions of losses of A and B, totalling $100.  

The flexible loss-offsetting rule in Italy is possible under the pooling system under which each subsidiary remains to a large extent a separate entity from the parent company. In contrast, a stronger application of the enterprise doctrine in other consolidation regimes (for example, Australia and the Netherlands) can not provide such flexibility as all group members in a consolidated group are treated as parts of a single enterprise. Losses incurred by individual group members during consolidation are therefore not separately identified with a particular company.

The flexible loss-offsetting rules in Italy are prone to abuse. Complex regulations have been introduced to tackle the use of group losses by the most profitable subsidiaries when they exit the consolidated group or when the group is de-consolidated.  

**Japan**  
As a consolidated group in general is treated as a single company, group losses can be carried forward for seven years under the general loss carryover rules applicable to companies.  

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99 The example is based on Example II in Leone & Zanotti, above note 37, at 192.  
100 For a brief discussion of these rules, see ibid, at 192-193.  
101 Article 81-9 CTA. The carry-forward is also subject to anti-avoidance rules similar to those applicable to companies in general: Article 81-9-2 CTA.
Chapter 6 Treatment of Losses

The Netherlands

A fiscal unity is in general treated as one single taxpayer. Losses incurred by the group are subject to the normal loss carryover rules, namely carry forward for nine years and carry back for one year.\textsuperscript{102} It is possible to carry back group losses to offset against pre-consolidation profits of group members, subject to similar attribution rules discussed above in the context of pre-consolidation losses.\textsuperscript{103}

The application of the enterprise doctrine in the Netherlands is taken one step further than other countries. If there is a change of composition of a fiscal unity (for example, a company joins or leaves an existing group, or an existing group is acquired by another consolidated group), the new fiscal unity is treated as a \textit{different} taxpayer from the original group for loss offset purposes.\textsuperscript{104} This implies that the net carried forward loss of the old group is treated as a pre-consolidation loss with respect to the new group, and the above-discussed profit attribution rules apply.\textsuperscript{105}

New Zealand

Tax losses incurred by a consolidated group – which is treated as one single company – belong to the group, instead of individual group companies.\textsuperscript{106} They are treated as losses incurred by a single company with respect to the

\textsuperscript{102} Article 20 Vpb.
\textsuperscript{103} Article 15ae(1)(b) Vpb.
\textsuperscript{104} Vries, above note 50, at 473. See also the example illustrating this policy in Müller, above note 50, at 267-268.
\textsuperscript{105} Article 15ae(1)(c) Vpb. Similar rules apply to carry-back of losses from the new fiscal unity to the old group: Article 15ae(1)(d) Vpb.
\textsuperscript{106} Section ID 1(1) ITA2007. An exception is for groups with mining companies: section ID 1(2) ITA2007.
loss carry-forward and group loss relief rules. The policy represents a faithful application of the enterprise doctrine.

Spain
Consistent with the enterprise doctrine, a consolidated group is subject to the same loss carry forward rules as a company. Group losses can be carried forward to offset against the group’s future taxable income for a maximum of fifteen years.\textsuperscript{107}

The United States
A consolidated group’s net tax loss incurred in a year (known as “consolidated net operating loss”, or CNOL) can be carried back or forward under the general loss carryover rules.\textsuperscript{108}

If part of a CNOL is attributable to a group member who filed a separate tax return (that is, not in the consolidated group) in the carry-backward or forward year, the CNOL in general is apportioned to that company.\textsuperscript{109} That portion is then carried to the company’s separate return year.\textsuperscript{110} The apportionment is based on actual tax loss figures for the year. In contrast, the AF rules in Australia are based on historical market values at the joining time. The U.S. approach provides a relatively more precise and reasonable outcome. The disadvantage is higher compliance costs of computing separate tax losses of group members.

\textsuperscript{107} Section 74(1) LIS.
\textsuperscript{108} Reg. 1.1502-21(a) & (c).
\textsuperscript{109} Reg. 1.1502-21(b)(2).
\textsuperscript{110} In general, the apportionment is according to the following ratio: “tax loss of the subsidiary for the year” to “sum of tax losses of all group members for that year”: Reg. 1.1502-21(b)(2)(iv)(B).
6.3.2 Group losses at leaving time

Australia

As explained above, under the strong single entity rule in Australia, group losses are treated as generated by the parent company alone, instead of by individual group members. It follows that those losses remain with the parent company when a subsidiary leaves the group.\[111\]

France

In France, when a subsidiary leaves a consolidated group, any accumulated group losses in general stay with the group.\[112\] This is in accordance to the enterprise doctrine, under which the group losses are treated as incurred by the group as a whole, instead of by individual group members.

Italy

In general, group losses stay with the group when a subsidiary leaves.\[113\] This policy is designed as an anti-avoidance provision to prevent group losses being taken over by a profitable subsidiary leaving the group.\[114\] However, a group may opt for a loss allocation method designed to restore the losses to the company that incurred them, provided the allocation method is pre-determined

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\[111\] Specific override of the exit history rule is required to ensure that the losses stay with the parent company at leaving time: section 707-410 ITAA1997.

\[112\] In particular, the tax law stipulates that group losses are not available to individual group companies: Article 223E CGI. There are some exceptions to this rule. For example, with the objective to reduce the adverse effects of the financial crisis in 2009, group losses may be allocated to subsidiaries at leaving time if, among other things, the exit of the company is due to the bankruptcy of the parent company: Borenstein & Sorensen, above note 96.

\[113\] This is so despite that it is possible for the group members to enter into an agreement on compensations for transfer of losses to the parent company. Such compensation payments are in general not subject to tax: Leone & Zanotti, above note 37, footnote 35 at 193.

\[114\] Ibid, at 192-193.
and fixed at the time of consolidation.\textsuperscript{115} This option provides more flexibility to taxpayers, but deviates from the enterprise doctrine.

\textit{Japan}

If a subsidiary leaves a group and has contributed to group losses, the company can carry forward those losses to its separate taxation years.\textsuperscript{116} The policy reflects a relatively strong influence of the separate entity doctrine during consolidation. The group correspondingly can not carry forward that portion of the group losses.\textsuperscript{117}

\textit{The Netherlands}

In the Netherlands, group losses in general stay with the consolidated group when a subsidiary leaves. However, similar to Italy, the parent company and the leaving subsidiary can jointly request an allocation of the group losses to the latter.\textsuperscript{118} The amount of losses attributable to the subsidiary is subject to the decision of the tax authority.\textsuperscript{119}

The old Dutch fiscal unity rules did not allow group losses to be allocated to a leaving subsidiary.\textsuperscript{120} The reason for removing the restriction was to facilitate reorganisation of an insolvent group.\textsuperscript{121} For instance, the parent company

\textsuperscript{115} Ibid, at 193.
\textsuperscript{116} Article 57(6) CTA. See also Komamiya, above note 42, at 398.
\textsuperscript{117} Article 81-9(4)(vi) CTA.
\textsuperscript{118} Article 15af(1)(b) & (2) Vpb.
\textsuperscript{119} Articles 15af(3) Vpb.
\textsuperscript{121} Stoel, ibid, at 17.
Chapter 6 Treatment of Losses

would not have sufficient future profits to offset the carry-forward group losses, while the new owner of the leaving subsidiary might be willing to pay for the value of the losses incurred by the subsidiary during consolidation.

Taxpayers are likely to welcome the allocation option, which gives them more flexibility to utilise their losses. The main practical problem of the policy is that the attribution rules tend to be complex. Another problem is the possibility of accelerating the utilisation of the allocated loss by transferring an asset with hidden reserve to the leaving subsidiary from another group member before the leaving time. The gain realised on disposal of the asset after the leaving time would then be offset by the allocated losses. A specific anti-avoidance provision aims in general to deny offset of the allocated losses against gains realised from such intra-group asset transfers.  

New Zealand

Group losses are treated as losses incurred by a single company for the purpose of loss carry-forward rules. Group losses remain with the consolidated group when a subsidiary leaves.

Spain

In Spain, if a subsidiary leaves a group and its losses incurred during consolidation have not yet been fully utilised by the group, it will be entitled to utilise a portion of the group’s net loss. This portion is determined based on the company’s contribution to the creation of this group loss. The

122 Article 15af(4) Vpb. As discussed above, similar restriction applies to the leaving subsidiary’s pre-consolidation losses.

123 Section 1D 1(1) ITA2007.

124 Section 81(1)(b) LIS. For a brief discussion of the attribution rules, see Ruiz, above note 5, at 622.
subsidiary will also inherit the remaining loss carry-forward time limit from the group.

Unlike Italy and the Netherlands which require election by both the parent company and the leaving subsidiary, the Spanish rule applies automatically to allocate group losses to a leaving subsidiary. Anti-avoidance provisions are required to deal with abuse of the allocation rules.\textsuperscript{125}

\textbf{The United States}

When a company leaves a consolidated group in the U.S., it files a separate tax return in that year. If any CNOL of the group that is attributable to the company may be carried to that separate return year, the CNOL will be apportioned to the company and carried to that year.\textsuperscript{126} The apportionment is made according to the formula discussed above in the context of “group losses during consolidation”. In particular, the portion is generally computed based on the ratio of “tax loss of the company in the tax year over that of all group companies in the year”.\textsuperscript{127} As CNOL is defined to be the consolidated group loss for a year,\textsuperscript{128} the apportionment is done for each consolidated tax year in which there is a CNOL that can be carried to the separate return year.

The policy of allocating a portion of the group loss to a leaving subsidiary reflects a relatively dominant influence of the separate entity doctrine in the U.S. consolidation regime.

\textsuperscript{125} Ruíz, ibid, at 621.
\textsuperscript{126} Reg.1.1502-21(b)(2)(i).
\textsuperscript{127} Reg. 1.1502-21(b)(2)(iv)(B).
\textsuperscript{128} Reg.1.1502-21(e).
6.3.3 Group losses at de-consolidation

**Australia**

As explained above, group losses are treated as generated solely by the parent company under the single entity rule in Australia. It follows that those losses remain with the parent company when consolidation ceases.

**France**

In general, tax losses incurred by a subsidiary member of a consolidated group that have been incorporated into the computation of the group’s losses are no longer deductible from the tax basis of the subsidiary. This position is maintained at de-consolidation, implying that the net tax losses of a consolidated group stay with the parent company in most cases.

**Italy**

In general, group losses stay with the parent company when a group is de-consolidated.

**Japan**

In Japan, the treatment for deconsolidation is similar to the case when a subsidiary leaves the group. In particular, if a group member has contributed

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129 Section 223E CGI.

130 There are exceptions to the general “stay with parent company” policy at de-consolidation. For example, if a group ceases consolidation due to certain circumstances (for example, merger of the parent company into another company, split of the parent company into two companies, or more than 95% of the parent company being acquired by another resident company), and the new group elects for consolidation, the old group may opt to allocate the consolidated losses to its group members that become members of the new consolidated group: the author is indebted to Nicolas Message for the information of these exceptions. Detailed discussion of these rules is beyond the scope of this thesis.

131 Article 123(4) TUIR.
to group losses, the company can carry forward those losses to its separate taxation years.\textsuperscript{132}

\textbf{The Netherlands}

At de-consolidation, carried forward group losses would be attributed to subsidiaries according to the “profit-split” method discussed above in the context of pre-consolidation losses.\textsuperscript{133} The parent company inherits any remaining group losses after the attribution to ex-group members. Such losses can be used to offset the parent’s own pre-consolidation profits (subject to the carry-back time limit) and its future profits.\textsuperscript{134}

Specific anti-avoidance provisions are designed to protect the “group loss share-out” policy from abuse.\textsuperscript{135} The share-out losses in general can not be used to offset against post-consolidation profits arising from assets which were transferred to the company with hidden reserves during consolidation, if those realised profits would not have been attributable to the company under the fiscal unity profit attribution rules discussed above in the context of pre-consolidation losses. Without these anti-avoidance provisions, the intra-group transfer of appreciated assets would otherwise accelerate utilisation of the share-out group losses.

\begin{footnotesize}
\textsuperscript{132} Article 57(6) CTA.
\textsuperscript{133} Article 15af(1)(b) Vpb; and Vries, above note 50, at 474.
\textsuperscript{134} Vries, ibid, at 474.
\textsuperscript{135} Articles 15af(4) & 15ag Vpb.
\end{footnotesize}

235
New Zealand

It appears that the law is silent on what should happen if a consolidated group dissolves.\(^{136}\) However, the tax law stipulates that tax losses of a consolidated group are treated as the losses of the group as if it is a single company, not as the losses of any particular group member.\(^ {137}\) Furthermore, a consolidated group continues to exist even if the number of group members is reduced to one.\(^ {138}\) With the absence of a specific provision for the allocation of group losses to individual group members, upon de-consolidation, all but one company could leave the consolidated group and the group loss stays with the last member of the group.

Spain

Similar to the case of a leaving subsidiary, if a group de-consolidates in Spain, any group losses would be attributed to the group members at the time of de-consolidation in proportion to their contribution to the group losses.\(^ {139}\) Anti-avoidance provisions exist to prevent abuse of the offset rules.\(^ {140}\)

The United States

Upon deconsolidation, group loss is apportioned to group members according to the same formula for a leaving subsidiary discussed above. In essence, CNOL of a consolidated tax year is apportioned according to the ratio of tax

\(^{136}\) Harris, above note 58, footnote 112 at 964. The author is indebted to Casey Plunket for clarifying the New Zealand rules on the issue.

\(^{137}\) Section ID 1(1) ITA2007.

\(^{138}\) Section FM 33 ITA2007.

\(^{139}\) Section 81(1)(b) LIS.

\(^{140}\) Vries, above note 50, at 621.
loss of the subsidiary and the total tax losses of all group companies for that year.\textsuperscript{141}

\textbf{6.4 Conclusion}

Policies of the treatment of pre-consolidation losses and group losses of the consolidation regimes in the eight countries are summarised in Table 7 below:

\begin{table}[ht]
\centering
\begin{tabular}{|c|c|c|c|c|c|c|c|c|}
\hline
\textbf{Losses} & \textbf{Policy} & \textbf{Au} & \textbf{Fr} & \textbf{It} & \textbf{Ja} & \textbf{Ne} & \textbf{NZ} & \textbf{Sp} & \textbf{US} \\
\hline
\hline
\textit{Pre-consolidation losses} & & & & & & & & & \\
\hline
Joining time & Quarantine & Before group loss & ✓ & ✓ & & & & & \\
& & After group loss & ✓ & ✓ & ✓ & ✓ & & & \\
& Transfer to parent company & ✓ & & & & & & & \\
& Cancellation & & ✓ & & & & & & \\
Leaving time & Stay with subsidiary & ✓ & ✓ & n/a & ✓ & ✓ & ✓ & ✓ & ✓ \\
& Stay with group & ✓ & & & & & & & \\
\hline
\hline
\textit{Group losses} & & & & & & & & & \\
\hline
During consolidation & Available to group & ✓ & ✓ & ✓ & ✓ & ✓ & ✓ & ✓ & ✓ \\
& Available to subsidiary & & & & & & & & & \\
Leaving time & Stay with group & ✓ & ✓ & ✓ & ✓ & ✓ & ✓ & ✓ & ✓ \\
& Allocate to subsidiary & ✓ & ✓ & ✓ & ✓ & ✓ & ✓ & ✓ & ✓ \\
De-consolidation & Stay with parent company & ✓ & ✓ & ✓ & ✓ & ✓ & ✓ & ✓ & ✓ \\
& Allocate to group members & ✓ & ✓ & ✓ & ✓ & ✓ & ✓ & ✓ & ✓ \\
\hline
\end{tabular}
\caption{Treatment of losses in the eight countries}
\end{table}

\textsuperscript{141} Reg. 1.1502-21(b)(2).
With respect to the treatment of pre-consolidation losses at joining time, all the eight countries, except Australia and Japan, adopt the quarantine policy, which is the preferred option on policy grounds. These six countries are divided on the issue of whether the offset of pre-consolidation losses should be before or after aggregating with other group members’ results. Four countries – namely the Netherlands, New Zealand, Spain and the United States – allow the offset only if the consolidated group as a whole has net taxable income. A problem of this policy is that the allocation rules of a consolidated group’s taxable income to a particular subsidiary tend to be complex. Furthermore, specific anti-avoidance provisions are required to deal with abuse of the loss offset rules, for example accelerating utilisation of pre-consolidation losses by intra-group transfer of assets with hidden reserves. In contrast, France and Italy allow offset of the pre-consolidation losses of a subsidiary with its own taxable income first before aggregating with other group members’ results. This policy reflects a stronger influence of the separate entity doctrine in their consolidation regimes. The advantage of the policy is simplicity, avoiding complex allocation rules to apportion a consolidated group’s taxable income to a subsidiary.

Australia allows transfer of pre-consolidation losses of subsidiaries to the parent company. This policy is shaped by the strong single entity concept – which deems a subsidiary to have disappeared upon consolidation for income tax purposes – and the desire to preserve the tax benefit being enjoyed by corporate groups under the old group loss relief regime. The loss transfer policy requires a set of complex and arbitrary AF rules to restrict the use rate of the transferred losses. The AF rules resemble a game of arithmetic. Though the policy in New Zealand was developed under similar pressure to maintain the tax benefit being enjoyed by corporate groups under the old group loss relief regime, the New Zealand model suggests that there is an
alternative policy to achieve the same objective without the problematic AF rules.

Nevertheless, the AF rules – despite being arbitrary and complex – do serve as a measure restricting the use rate of pre-consolidation losses. This is especially so given that the AFs of a consolidated group can only be adjusted downwards under all possible adjustment events. The AF rules – ironically because of its arbitrariness – also avoid a common problem of other consolidation regimes: specific anti-avoidance provisions are not required in Australia to prevent abuse of loss offset rules by intra-group asset transfers. In the end, the AF regime is perhaps a rough but working model for the pre-consolidation loss issue.

Japan adopts a different policy on pre-consolidation losses from the other seven countries. Those losses in general are cancelled upon consolidation unless, among other things, the parent company has owned the subsidiary for at least five years before the joining time. Revenue and anti-avoidance concerns are the main reasons for this harsh policy. It may also reflect the less-than-enthusiastic attitude of the government towards the consolidation regime.

At leaving time, all the six countries that adopt the quarantine policy at joining time have a policy that properly reflects the transition between the two doctrines. The leaving subsidiary continues to be entitled to its pre-consolidation losses (if still available for carry-forward). In contrast, the strong single entity rule in Australia prevents a leaving subsidiary from retrieving its pre-consolidation losses from the parent company. This is in general a non-issue in Japan if pre-consolidation losses are cancelled at the joining time.
With respect to the treatment of group losses, all the eight countries apply the enterprise doctrine during consolidation by treating group losses as those of a single company. The U.S. is unique in allowing group losses to be apportioned to a particular subsidiary for carry back or forward to its separate tax return years. The policy reflects a relatively strong influence of the separate entity doctrine in the U.S. consolidation regime.

The policies of the eight countries are less convergent on the treatment of group losses at leaving or de-consolidation time. This demonstrates that transitions between the two doctrines are more difficult to handle. A strict application of the enterprise doctrine implies that group losses should be treated as losses incurred by the enterprise as a whole and should not be apportioned to individual group members. This is the position for group losses at leaving time in three countries: Australia, France and New Zealand.

In three other countries — namely Japan, Spain and the U.S. — a portion of the group losses is allocated to a leaving subsidiary. The policy reflects a stronger influence of the separate entity doctrine in the consolidation regimes. It also implies that compliance costs are higher whenever a subsidiary leaves a group.

The positions in Italy and the Netherlands are less clear cut. While in general group losses stay with a consolidated group, they also allow the group to elect allocating group losses to a leaving subsidiary. The policy provides more flexibility to corporate groups, and thus achieves the policy objective of competitiveness. However, the dual policy increases complexity and is subject to abuse.
The eight countries are divided on the treatment of group losses at de-consolidation time. The enterprise doctrine does not seem to offer a clear answer on this issue. On the one hand, one may argue that as the group loss is generated by the enterprise as a whole under the enterprise doctrine, the group loss should not be allocated to individual group members. This policy is relatively simple, as allocation rules of group losses to individual group members tend to be complex. On the other hand, it may also be argued that the de-consolidation time represents a transition between the two doctrines. As the group is disintegrated back to its individual group members, the group’s tax attributes, including tax losses, should revert to each group member.

Four countries – namely Australia, France, Italy and New Zealand – in general adopt the policy that group losses stay with the parent company, while four countries – namely Japan, the Netherlands, Spain and the U.S. – apportion group losses to individual group members at de-consolidation time.

In summary, the policies on the treatment of losses – which is possibly the most important benefit of a consolidation regime – in the eight countries do not always converge. The countries are divided on the issues of (1) whether to offset pre-consolidation losses of a subsidiary before or after aggregating into the group result; (2) whether to allocate group losses to a leaving subsidiary; and (3) whether to allocate group losses to each group member at de-consolidation. The divergent policies reflect the difficult compromise between not only conflicting tax policy objectives including simplicity, neutrality, competitiveness and anti-avoidance, but also the tension between the enterprise doctrine and the separate entity doctrine.
The next chapter deals with the treatment of assets (other than intra-group shareholdings) in a consolidated group. The treatment of intra-group shareholdings is analysed separately in Chapter 8.
CHAPTER 7
TREATMENT OF ASSETS

7.1 Introduction
This chapter analyses and compares the policies on the treatment of assets in the consolidation regimes in the eight countries. The issues of intra-group shares and the associated dual cost bases issue are analysed in the next chapter.

In the context of consolidation, assets held by subsidiaries present problems in three situations:

(1) at joining time: that is, when a subsidiary joins a consolidated group;
(2) during consolidation; and
(3) at leaving time: that is, when a subsidiary leaves a consolidated group.

The problems arise from the interaction and transitions between the separate entity doctrine and the enterprise doctrine. For each of the situations, alternative policy options are analysed, followed by the comparison of the policies and experience of the eight countries.
7.2 Joining time: transition between the two doctrines

The basic problem at joining time is how the tax attributes of a joining subsidiary should be treated when the company is transited from being taxed under the separate entity doctrine to the enterprise doctrine. Pre-consolidation tax attributes refer to those of the subsidiary before joining a consolidated group, including tax costs of assets owned by the subsidiary, and unrealised gains (or losses) in those assets.

Alternative policy options to deal with the transition at joining time include:

(1) quarantine;
(2) deemed disposal;
(3) rollover; and
(4) reset cost base.

(1) Quarantine:
Under this policy option, pre-consolidation tax attributes are quarantined and reserved for the subsidiary, and are not passed on to the parent company or the consolidated group. At first glance, this alternative may appear to be inconsistent with the enterprise doctrine which dictates that the subsidiary should be treated, not as a separate entity, but as part of the enterprise of the group.

However, transitional issues can be dealt with effectively only by defining clearly when the transition is. As the transition is at the point when the subsidiary joins a consolidated group, one may argue that the tax attributes of a subsidiary before joining consolidation should stay with the subsidiary under the separate entity doctrine, while after the transition its tax attributes...
generated during consolidation should be dealt with under the enterprise doctrine.

Under the separate entity doctrine, assets of a company – despite being a subsidiary of a parent company – are recognised as owned by the company itself. This raises the question of what should happen when the enterprise doctrine takes over and the company is treated as part of a consolidated group. Under the quarantine policy, the enterprise doctrine commences to apply upon consolidation. Gain or loss on assets accrued before joining time is attributed to the subsidiary in accordance with the separate entity doctrine upon sale of the assets to third parties. If the sale is intra-group, that portion of the gain or loss would not be recognised immediately in accordance with the enterprise doctrine, but remain attributable to the subsidiary.

The quarantine policy would impose high compliance costs not only to determine the accrued unrealised gain or loss at joining time and during consolidation, but also to trace the movement of the assets throughout the consolidation cycle. The fact that none of the eight countries adopts this policy in their consolidation regimes suggests that the policy is unacceptable to most countries.

(2) Deemed disposal:
Under this policy option, assets are deemed to have been transferred to the consolidated group at their market values at joining time. Unrealised gains or losses on assets owned by a subsidiary before the transition are recognised immediately. The cost bases of the assets to the consolidated group are their market values at the joining time.
This policy option represents a clear cut transition between the two doctrines. It is also less difficult to comply with and administer than the quarantine policy. However, in practice, it is difficult for either governments or taxpayers to accept the policy, as immediate taxation of unrealised gains contradicts the realisation principle and renders the consolidation regime less attractive. The valuation of assets would also increase compliance costs for taxpayers and policing costs for tax authorities. In fact, this policy option is uncommon in practice.

(3) Rollover:
Under this policy option, pre-consolidation tax attributes are rolled over to the consolidated group. Pre-consolidation assets of a joining subsidiary are treated as owned by the consolidated group at the original cost bases. Subsequent sale of these assets to a third party is recognised by the group. The whole amount of gain or loss on disposal – including the amount attributable to pre-consolidation period – is attributed to the group. This policy option arguably pushes the logic of the enterprise doctrine too far, and effectively applies the doctrine before the transition. However, it complies with the realisation principle, and avoids the complexity arising from valuation of assets at joining time. This policy also promotes the policy objective of competitiveness by deferring the taxation time to the actual disposal of the asset.

1 For example, see discussion of this issue in European Commission, “Issues related to business reorganisations” (CCCTB/WP/039, CCCTB WG, 2006), paragraph 13.

2 Japan is the only country among the eight countries that adopts this policy in its consolidation regime. The Netherlands adopts this policy for shareholdings in joining subsidiaries that are not eligible for participation exemption. See Chapter 8 Section 8.2 for more detail.
(4) Reset cost base:
Under this policy, the original cost bases of assets in a subsidiary are reset at joining time. In broad terms, the policy is designed to replace the original cost base by a new cost base which reflects the acquisition cost of the shares in the joining subsidiary. This is an unusual policy adopted only in Australia. It is analysed in detail below in the section on Australia.

The actual policies on the treatment of assets at joining time in the consolidation regimes in the eight countries are analysed in the following material.

Australia

As discussed in Chapter 4, the fundamental principle underlying the consolidation regime in Australia is the single entity rule ("SER"), under which subsidiaries in a consolidated group are treated as "parts of the head company". The policy choice of adopting the strong SER, which effectively collapses multiple levels of ownerships into one, leads to the important issue of how to determine the cost bases of subsidiaries' assets that are now deemed to be owned directly by the parent company.

Australia adopts the world's first "asset-based" model to deal with this issue. To facilitate analysis and evaluation of the complex new model and its policy rationales, it is necessary to discuss the model in a relatively more detailed manner than other countries in this section, covering not only issues at joining time, but also its effect during consolidation and at leaving time.

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4 Section 701-1 ITAA1997.
At this point, it is important to understand that the more common policy of rollover – which is the predominant policy in most other consolidation regime – does not mesh well with the strong SER. Under the rollover policy, gain or loss on intra-group asset transfers during consolidation is deferred and later recaptured when either the transferor or the transferee leaves the group. This policy is ruled out by the Australian government’s determination to deal with the dual cost bases issue which dictates that intra-group asset transfers are ignored completely for income tax purposes (emphasis added):\(^5\)

There would be tax-free movement of assets, even whole business, within a group without the need to adhere to formal rollover arrangements ... The transfer of assets ... within a consolidated group would have no tax consequences or compliance requirements.

The policy of ignoring completely intra-group asset transfer implies that, among other things, the pre-consolidation cost bases of shares in a subsidiary become irrelevant, as the company may carry very different assets when it later leaves the group. It dictates that the cost bases of shares of a leaving subsidiary would have to be reconstructed at the leaving time.\(^6\)

The government considered two policy options to reconstruct the cost bases of shares in a leaving subsidiary:\(^7\)

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\(^6\) The issue of reconstructing the share cost bases is discussed in more detail in Chapter 8 Section 8.2.

\(^7\) For a detailed discussion of the two models, their key features and how they work, see *A Platform for Consultation*, above note 5, at 572-578.
(i) the entity-based model:
Under this model, the assets keep their pre-consolidation cost bases. The cost bases of shares in a leaving subsidiary are determined by adjusting the original cost bases for, among other things, any transfer of assets in the company during consolidation.

(ii) the asset-based model:
Under this model, the cost bases of shares in a subsidiary is pushed down to its underlying assets upon consolidation. Pre-consolidation cost bases of assets in general are erased and replaced by the reset cost bases forever. When the company leaves the group, the share cost base is reconstructed by pushing up the cost bases of assets that it takes away from the group.

Australia chose the asset-based model primarily due to compliance and administrative costs of tracing intra-group asset transfers under the entity-based model. The policy choice of this asset-based model is also consistent with the underlying rationale of the SER, namely to treat the whole consolidated group as one single company with only one level of ownership in the group’s assets.

8 Review of Business Taxation, A Tax System Redesigned (“Ralph Report”) (1999), at 527. This rationale is also stipulated in the law: section 705-10(3)(b) ITAA1997. For a brief history of the design of the "world-first" asset-based model presented in the form of a personal memoir, see Geoffrey Lehmann, “An Assessment of Australia’s Tax Consolidation Regime” in Geoffrey Lehmann (ed), Business Tax Reform - Meet the Critics, Australian Tax Research Foundation Conference Series (2007, Australian Tax Research Foundation, Sydney). It is interesting to note that "the architect of the asset-based model was ... a middle level Treasury official ... close to retirement, who had been an economics lecturer [and did retire before the consolidation design process was concluded]": ibid, at 11 and 13.
A complex set of rules – known as the tax cost setting ("TCS") rules – are designed to achieve the push down of share cost base to the underlying assets.  

The objective of the TCS rules is stipulated as follows:

- to recognise the head company’s cost of becoming the holder of the joining entity’s assets as an amount [consisting] of the cost of the groups’ membership interests in the joining entity, increased by the joining entity’s liabilities and adjusted to take account of the joining entity’s retained profits, distributions of profits, deductions and losses.

In other words, a subsidiary’s liabilities (identified and measured under accounting rules) are added to the cost bases of shares in the company and adjustments are made for profits and losses of the company to arrive at an amount known as the “allocable cost amount” ("ACA"). The ACA is then generally allocated to the assets in the subsidiary according to their market values at the joining time.

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9 In the government’s words, “the group’s cost of membership interests is stored in its cost of assets”: EM to May 2002 Consolidation Act, paragraph 5.108. Though appearing to be similar to accounting rules on consolidation, the tax cost setting rules are very different in detail: Tony Stolarek, “The tax treatment of consolidated groups: managing major tax change” in Chris Evans and Richard E Krever (eds), Australian Business Tax Reform in Retrospect and Prospect (2009, Thomson Reuters, Sydney), at 218.

10 Section 705-10(2) ITAA1997. The amount allocated to assets in a company is computed under an 8-step process stipulated in section 705-60 ITAA1997. For a diagram that conveniently summarizes the TCS steps at joining time, see ATO, Consolidation Reference Manual (available at www.ato.gov.au), C2-2-110 (which is reproduced in Appendix A Section A.1.1).

11 Section 705-60 ITAA1997.

12 Section 705-35(1)(c) ITAA1997. Certain assets (such as Australian currency and receivables) – known as “retained cost base assets” – retain their cost bases: section 705-25 ITAA1997. The amount of these retained cost bases are subtracted from the ACA before the balance is allocated to the remaining assets (known as “reset cost base assets”): section 705-35(1)(b) ITAA1997.
An important feature of the TCS rules is that it is possible to have a reset cost base higher than the original cost base. This is possible if for example a parent company pays a premium price for a subsidiary, exceeding the tax values of the underlying assets. Allowing “step-up” of tax cost bases of assets in a joining subsidiary is a unique feature of the consolidation regime in Australia.

The government repeatedly states that the objective of the TCS rules is to align costs of shares with that of underlying assets of a subsidiary.\(^\text{13}\) However, it is doubtful if the objective is achieved in practice. It has been observed that (emphasis added): “In an asset acquisition, the purchase price is allocated to the assets and this becomes the starting tax base [of the assets] ... In contrast, where the shares are acquired, an ACA calculation is required to be undertaken ... which ... may give a very different tax base to that achieved under an asset sale”.\(^\text{14}\) The mis-alignment is caused primarily by the various adjustments – for example, accounting liabilities are added to the ACA amount – to the share acquisition price in the TCS calculations.

Detailed discussion of the TCS rules is presented in Appendix A. Below is a summary of the major problems of the rules.

(1) Flawed theory

The TCS rules at joining time mix the cost bases of shares in a subsidiary with its accounting liabilities and other tax attributes, which may have different valuation times. The aggregate amount is then allocated to the assets of the subsidiary and reset their cost bases. By adding together tax items with

\(^{13}\) For example, sections 701-10(3) & 705-10(3) ITAA1997.

accounting items, the intriguing question is what the sum stands for. What does the resulting “reset” cost base of an asset represent? It is difficult to find a satisfactory answer. For example, accounting liabilities for a supermarket chain may also include “provision for self-insured risks” which represents the estimated liability for workers’ compensation and public liability claims based on actuarial valuations. It is puzzling why these items – which basically are estimates required under the accounting standards for financial reporting purposes – should be included in the ACA and pushed down into the reset cost bases of assets in the company.15

The fact that a parent company may have a capital gain or loss in the TCS process is evidence of the flawed theory.16 It is hard to comprehend why at joining time the parent company can have a capital gain or loss without any transfer of assets. The problem is that the capital gain or loss is artificially manufactured by the TCS rules.

The “reset” cost base stay with the asset even if the subsidiary subsequently leaves consolidation. The original “real” cost of the asset is lost forever once it passes through the consolidation process.17

15 What happens if the provision is different from the realised amount? It would be a nightmare if the TCS calculation has to be redone every time a provision is realised. The solution in Australia is to treat the difference as a capital gain or loss of the parent company: CGT event L7 under section 104-530 ITAA1997. However, there are many problems associated with the treatment and the government has repealed the CGT event in 2010. This means that over- or under-provisions in financial statements become a permanent component in the reset cost bases under the TCS regime.

16 For example, a parent company may have a capital loss if some of the allocable cost amount cannot be allocated to any asset: CGT Events L4 & L8 in sections 104-515 & 104-35 ITAA1997. In total there are seven (eight before 2010) CGT events that may be triggered by the TCS calculations.

17 The reset cost bases of assets also have significant implications for the cost bases of shares in a leaving subsidiary: see discussion in Chapter 8 Sections 8.2 and 8.4.
(2) Complexity
The TCS rules are very complex and occupy over 100 pages of legislation.\(^{18}\)
Compliance costs are high. In practice, especially for large corporate groups, identification of all assets (especially intangibles) can be an art instead of science. The meaning of “assets” and “liabilities” is also controversial.\(^{19}\)
Valuation of assets and liabilities is problematic. The administrative and policing costs of the ATO are also very high.\(^{20}\)

(3) Avoidance opportunities
The complex TCS regime provides ample tax avoidance opportunities. Planning opportunities can arise from valuation of assets,\(^{21}\) different depreciation rates among assets, and the meaning of “assets” (especially identification of intangibles) and “liabilities”.\(^{22}\)

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\(^{18}\) Divisions 705 and 713 ITAA1997. As discussed above, when a subsidiary joins a consolidated group, first it has to go through an 8-step process to arrive at the “allocable cost amount”, which will be allocated to each individual asset of the company: Section 705-60 ITAA1997. This is just the first part of a 4-part process to complete the tax cost setting process. The whole process is repeated for every level of shareholdings in the consolidated group, until all costs of shareholdings are allocated to individual assets. The TCS calculations are so complex that the tax law stipulates that certain errors in the calculation would be taken to be correct if, among other things, they are worked out “in purported compliance” with the TCS rules: section 705-315 ITAA1997. In that case, the mistake will result in a capital gain or loss for the parent company.

\(^{19}\) The ATO has issued several tax rulings explaining its positions on the meanings of “asset” and “liability”: TR2004/13, TR2004/14 and TR2006/6. For an interesting illustration of the problems in relation to “liabilities” and the resulting “notorious provision” in the ACA rules (section 705-80 ITAA1997), see the “accrued $100 million liability for poisoned pies sold by a pie shop” example in Lehmann, above note 8, at 279.

\(^{20}\) In addition to the inherent problems associated with valuation of assets, the policing cost is particularly high as the tax cost setting rule can result in “step-up” basis of assets: ATO, PS LA 2004/12, paragraphs 7 & 10.

\(^{21}\) Valuation is particularly difficult and inherently subjective for intangibles, such as goodwill. Taxpayers in general would prefer a lower valuation of goodwill in the context of tax cost setting exercise, as goodwill is not eligible for depreciation in Australia.

\(^{22}\) For example, the meaning of “liability” in the context of the tax cost setting rules was the key issue in Envestra Ltd vs Commissioner of Taxation [2008] FCA 249.
accounting standards may allow a choice between alternative accounting policies.\(^\text{23}\)

\*Reset cost bases: a good policy?*

The TCS rules offer an advantage that is unusual in other consolidation regimes: intra-group asset transfers within a consolidated group are ignored *completely*. Unlike the rollover policy in most other consolidation regimes, there is no need to trace movement of assets during consolidation, keep records of any deferred gain or loss, or recapture the gain or loss when either the transferor or transferee leaves the consolidated group. This implies lower compliance and administrative costs during consolidation. However, the advantage comes at a high price: the problematic and complex TCS regime.

The TCS regime dictates a road of no return for cost bases of most assets in a consolidated subsidiary. The cost bases of many assets are “reset” at the joining time. The “reset” cost base replaces the “real” cost base forever and stays with the asset even if the subsidiary subsequently leaves the group. The original cost of the asset to the subsidiary is erased forever.

A proper recognition of the transitions between the enterprise and separate entity doctrines should ensure that, when the subsidiary leaves the group, the cost base of an asset which has always been held by the company throughout the consolidation cycle should be reinstated to its actual cost. The TCS regime fails to achieve this outcome. The failure to revert properly to the separate entity doctrine represents a fundamental problem of the asset-based model. It can also result in taxation of artificial gain generated from the TCS process.

\(^{23}\) The ATO recognises the problem and tries to limit the scope for manipulation: TR2006/6 paragraphs 9 & 20. The ATO’s position was tested and confirmed in *Envestra Ltd v FCT* [2008] FCA 249.
The policy of allowing step-up basis under the TCS regime is too generous. It effectively allows converting part of share acquisition cost into depreciable cost bases, the extent of conversion depending on the relative amount of depreciable assets of the subsidiary involved, their market values, and also the aggressiveness of taxpayers to take advantage of the rules. The step-up basis could also reduce gain or even generate artificial losses on future disposal of capital assets.

**France**

The domestic consolidation regime in France is a pooling system, subject to certain adjustments at group level.\(^{24}\) In particular, each company in a consolidated group continues to calculate its own taxable income.\(^{25}\) The group’s taxable income or loss is in general determined at the group level as the algebraic sum of the results of each group member.\(^{26}\) A pooling system is essentially a “halfway” application of the enterprise doctrine. Subsidiaries in a group remain to a large extent as separate entities from the parent company for income tax purposes.

Under the pooling system, assets of a joining subsidiary continue to be treated as owned by the company. It follows that there are no tax implications for those assets at joining time. If the consolidated subsidiary sells the asset to a third party, the capital gain or loss would be included in the taxable income or loss of the subsidiary, which in turn would be aggregated into the group’s

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\(^{24}\) Article 223B CGI.


\(^{26}\) Intra-group transactions with respect to fixed assets are eliminated at the group level: Ioanna Mitroyanni, *Integration Approaches to Group Taxation in the European Internal Market*, EUCOTAX Series on European Taxation (2008, Kluwer, Alphen aan den Rijn), at 124.
taxable income or loss.\textsuperscript{27} Any unrealised gain accrued before joining time would be taxed in the hands of the group, instead of the subsidiary.

At joining time, the pooling system operates in a much simpler manner than the asset-based model in Australia, under which the tax cost bases of assets are reset under the complex TCS rules. However, the operation of the pooling system becomes more complicated during consolidation as it is necessary to trace the movement of assets within the consolidated group, and keep track of any deferred gain or loss on the intra-group asset transfers.

\textit{Italy}

Similar to France, the domestic consolidation regime in Italy is a pooling system. Every company in a consolidated group has to determine its taxable income based on normal corporate tax rules as if it were a separate taxpayer, and file its own tax return to the tax authorities.\textsuperscript{28} The only difference is that it does not have to compute its tax liability in the return. Taxable income of a consolidated group in general is computed as the algebraic sum of the total taxable income of all the group member companies.\textsuperscript{29} Each subsidiary remains to a large extent as a separate entity from the parent company for income tax purposes. It follows that there is no tax implication on the assets owned by a subsidiary when it joins a consolidated group.

\textit{Japan}

The consolidation regime in Japan is also a pooling system. A consolidated group’s taxable income or loss in general is computed by adding together

\textsuperscript{27} The group’s capital gain or loss is basically the algebraic sum of the capital gains and losses of each of the group members, subject to certain adjustments: Article 223D CGI.


\textsuperscript{29} Article 118(1) TUIR.
individual group member’s taxable income or loss, subject to various adjustments.\footnote{Article 81-3 CTA. For example, intra-group dividends are eliminated at the group level.} 

Japan is the only country among the eight countries adopting the deemed sale policy for assets at joining time. It requires the following assets of a joining company be marked-to-market at joining time, with any resulting gain or loss recognised in the hands of the company:\footnote{Article 61-11 CTA. Under the 2010 tax reform in Japan, effective 1 October 2010, the mark-to-market rule is not applicable if the 100% ownership relationship between the parent company and the joining subsidiary will cease within two months from the joining time: PwC, “Asia Pacific Tax Notes” (June 2010) Issue 23 (available at www.pwccn.com), accessed on 29 December 2010, at 29-30.}

1. fixed assets;
2. land;
3. securities (except those held as revenue assets); and
4. monetary claims.

Certain assets are excluded from the mark-to-market rule, including:

1. certain depreciating assets subject to special accelerated depreciation;
2. an asset with unrealised gain or loss less than the lesser of 50 per cent of the capital of the subsidiary or 10 million yen.\footnote{Article 61-11(2) and Cabinet Order 122-12(1).} 

A strict application of the deemed sale policy would imply high compliance costs and render the consolidation regime less attractive to taxpayers. The rule is subject to a number of exceptions, including assets owned by the parent
Chapter 7 Treatment of Assets

company and any subsidiary wholly-owned by the parent company for more than five years.33

**The Netherlands**

In the Netherlands, activities, assets and liabilities of subsidiaries in a consolidated group – known as fiscal unities – in general are treated as if they were those of the parent company.34 The Dutch consolidation regime therefore applies the enterprise doctrine more comprehensively than the pooling systems in say France and Italy.

The Netherlands in general adopts the "rollover" policy for assets owned by subsidiaries under its consolidation regime. No tax is levied on unrealised gain of assets at joining time. However, the fiscal unity regime adopts the "deemed sale" policy for interests held by the parent company in its subsidiaries at joining time.35 Intercompany receivables in general are also marked to market at joining time.36 The deemed sale policies are designed to avoid loss of claims on hidden reserves in these shares and receivables (if any).37

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33 Article 61-11 CTA.
34 Article 15(1) Vpb. In other words, subsidiaries in general are treated as if they are dissolved into the parent company: Johann Müller, *The Netherlands in International Tax Planning* (2005), at 247.
35 Article 15ab(1) Vpb. This policy is discussed in more detail in the next chapter on intra-group shareholdings.
36 Article 15ab(6) Vpb. For an example of this situation, see Müller, above note 34, at 253.
New Zealand

New Zealand does not have a general capital gain tax. There is no tax implication for transfer of assets, except for depreciable assets, revenue assets, trading stock and financial arrangements.38

In general, the New Zealand tax law treats “companies that are part of a consolidated group as if they were a single company”.39 Taxable income of a consolidated group is the sum of taxable income of all group members, subject to certain adjustments (for example, intra-group transactions).40 In other words, the New Zealand consolidation regime is a pooling system. Similar to France and Italy, upon joining a consolidated group, there is no specific tax implication for assets owned by the subsidiary.

Spain

The consolidation regime in Spain is also a pooling system.41 Subsidiaries remain separate taxpayers keeping their own books and accounts and preparing individual tax computations, while the parent company is primarily responsible to pay tax on the group profit.42 Taxable income of a consolidated group is determined by adding together individual taxable income of all group members, subject to certain adjustments (such as intra-group transactions).43

39 Section FM2 ITA2007.
40 Section FM3 ITA2007.
42 Ibid, at 617.
43 Section 71 LIS.
As subsidiaries remain as the owners of their assets for tax purposes during consolidation, there is no tax implication on the assets at joining time.

**The United States**

The U.S. also adopts the pooling system in its consolidation regime. A consolidated group’s taxable income is computed by taking into account the separate taxable income or loss of each group member, subject to specific rules for intra-group transactions. In general, the regime does not apply the enterprise doctrine consistently; instead it is a mixture of rules applying either of the two doctrines in different situations. For instance, the Regulations governing intra-group transactions state explicitly that the rules treat consolidated group members “as separate entities for some purposes but as divisions of a single corporation for other purposes”.

In broad terms, each group member computes its taxable income as a separate entity. Adjustments are then made at the group level treating the group member as a division of a single corporation. There is no specific tax implication on the assets owned by a subsidiary when it joins a consolidated group.

**7.3 During consolidation: Intra-group asset transfer**

Under the enterprise doctrine, intra-group asset transfer during consolidation should have no tax implication for the group. The transfer should be treated as if it is a transfer between divisions of a single company. This outcome can be achieved by two similar but subtly different policy options:

1. rollover; and

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44 Reg. 1.1502-11(a).

45 Reg. 1.1502-13(a)(2).
(2) neutralisation.

Under the rollover policy, the cost base of an asset that is transferred between group members is rolled over from the transferor to the transferee, without immediate recognition of gain or loss on the transfer. The deferred gain or loss is recaptured when for example the asset is sold to a third party outside the consolidated group.

An alternative policy option is the neutralisation policy. Under this policy option, gain or loss on intra-group asset transfer is recognised at the individual company level, but is eliminated at the group level. This alternative does not apply the enterprise doctrine consistently. Subsidiaries maintain their separate entity status from the parent company to a large extent. Tax implications of intra-group asset transfers are eliminated only when individual companies' results are pooled together at the parent company level.

The neutralisation policy option has a higher compliance cost than the rollover policy. Each group member has to prepare its own tax computations, and the group has to keep track of deferred gain or loss on intra-group asset transfer. Adjustments for depreciation claimed by the transferee can be especially cumbersome.

Another possible policy option is to deem intra-group asset transfer to be made at tax written down value. This is the proposed policy in the CCCTB project in the EU: European Commission, “CCCTB: possible elements of a technical outline” (CCCTB/WP/057, CCCTB WG, 2007), paragraph 106. The advantage of this option is that, as the transfer is deemed to be made at the tax written down value, there would be no gain or loss on the transfer for income tax purposes, thus avoiding the tracing and recapturing of deferred gain or loss. However, as none of the eight countries adopt this option in their consolidation regimes, it is not discussed in detail.

See discussion of the issues with respect to deprecating assets in the U.S. consolidation regime below.
The following material analyses and compares the policies of intra-group asset transfers in the consolidation regimes in the eight countries.

**Australia**
As discussed in Section 7.2 above, under the "asset-based" model, when a subsidiary joins a consolidated group, its assets are deemed to be owned directly by the parent company. The implication of this deeming provision is that any intra-group asset transfer within a consolidated group is ignored completely for income tax purposes. There is no need to trace movement of assets within the group, or to recapture deferred capital gain or loss on the transfer.\(^48\) If the consolidated group sells the asset to a third party, any capital gain or loss is recognised by the parent company and is calculated based on the reset cost base of the asset determined under the tax cost setting rules at the joining time.\(^49\)

As explained above, the Australian policy offers a tax-friendly environment for corporate groups during consolidation. However, serious problems arise at both the joining and leaving time. The tax cost setting rules are complex, and can produce arbitrary and inappropriate tax outcomes.

**France**
As the consolidation regime in France is a pooling system, assets of a subsidiary continue to be treated as owned by the company during

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\(^48\) Before the introduction of the consolidation regime in Australia, transfer of assets within a wholly owned group in general would be eligible for rollover relief. The scope of this rollover relief was substantially tightened upon the introduction of consolidation, as a measure to effectively force corporate groups to elect for consolidation. Since then, the rollover relief is only available to transfers within a wholly owned group if at least one of the parties involved is a non-resident: Subdivision 126-B ITAA1997.

consolidation. If an asset of a consolidated group member is transferred to another group member during consolidation, the company has to include the resulting capital gain or loss in its own tax computation. However, such gain or loss is excluded from the group’s taxable income or loss. The French regime “neutralises” gain or loss on intra-group asset transfers at the group level.

If the asset is subsequently sold by the group to a third party outside the group, the deferred capital gain or loss is recaptured at the group level. Remembering that the French consolidation regime is a pooling system, this recapture rule is required to ensure that the whole gain or loss realised on the asset is recognised by the group upon the sale to a third party.

**Italy**

Similar to France, the consolidation regime in Italy is a pooling system. Each subsidiary has to prepare its own tax computation during consolidation, including capital gain or loss on any intra-group asset transfer. Before 1 January 2008, such gain could be – at the option of the consolidated group – “neutralised” at the parent company level, when the latter computed the group’s taxable income. The transferor and the transferee had to elect

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50 Article 223F CGI.


52 Article 223F CGI.

53 For instance, if Company A makes an intra-group transfer of asset (cost being $100) to Company B for $160 during consolidation, the gain of $60 is deferred. When B subsequently sells the asset to a third party for say $200, B would realise a capital gain of $40, which would be included in the group’s taxable income. The $60 deferred gain is then recaptured by the group, resulting in a total gain of $100 on the disposal of the asset.

54 Article 121 TUIR.

55 Articles 122 & 123 TUIR.
together at the time of transfer to enjoy the rollover relief. 56 In other words, Italy allowed consolidated groups to elect for the neutralisation policy for intra-group asset transfer. 57

The deferred gain would be recaptured at the group level in one of the following circumstances: 58

1. either the transferor or the transferee left the consolidated group;
2. the transferee in turn transferred the asset to another group company, but the parties did not elect for the tax-neutrality treatment;
3. the transferee sold the asset to a third party outside the consolidated group; or
4. the transferee sold the asset at a loss.

An anti-avoidance provision existed to prevent abuse of the neutralisation policy by shifting unrealised capital gain to a group member that has pre-consolidation losses. In particular, if the transferee subsequently realised capital gain on disposal of the asset, it could not utilise its pre-consolidation losses to offset against such gains. 59 This problem arises as pre-consolidation losses are quarantined at the subsidiary level. The interaction between this policy and the application of the enterprise doctrine during consolidation creates the opportunity to shift “hidden” capital gain of the group to a particular subsidiary which has more capacity to offset the gain.

56 Article 123 TUIR. Other requirements for the “tax-neutrality” treatment include: (1) the assets must be fixed assets, and (2) the intra-group transfer resulted in a gain. Capital losses were not covered by the provision. In fact, as the treatment was optional, in practice companies would most likely only elect when the intra-group transfer resulted in a gain.
57 For a numeric example of the operation of this “tax-neutrality” regime for intra-group asset transfer, see Leone & Zanotti, above note 28, at 194.
58 Article 124 TUIR and Leone & Zanotti, ibid, at 195.
59 Article 123(2) TUIR.
Since 1 January 2008, the neutralisation policy has been abolished. Intragroup asset transfers are now subject to immediate taxation in Italy. This is a significant departure from the enterprise doctrine, and effectively reduced the consolidation regime to a group pooling regime. Given the consolidation regime was introduced in 2004, this significant change in policy in a short time suggests that the Italian regime is quite volatile.

**Japan**

In general, gain or loss on intra-group transfer of the following assets are neutralised at the group level and are deferred until either the asset is sold to a third party outside the group or the transferor leaves the group.

1. fixed assets;
2. land;
3. securities (except those held as revenue assets); and
4. monetary claims.


61 Article 81-10 CTA. For a brief discussion of the mechanism of the rollover relief, see Fumihiro Komamiya, “Branch Report: Japan” in International Fiscal Association, *Cahiers de Droit Fiscal International Volume 89b: Group Taxation* (2004), at 398-399. Since 1 October 2010, the rollover relief has been extended to wholly-owned groups of resident companies that have not elected for consolidation: IBFD, “Country Analyses - Japan - Corporate Taxation (online database)” (available at www.ibfd.org), accessed on 28 December 2010, paragraph 8.4. This is one of the measures introduced under the 2010 tax reform in Japan. For more detail of the new intra-group asset transfer regime, see PwC, “Asia Pacific Tax Notes” (June 2010) Issue 23 (available at www.pwccn.com), accessed on 29 December 2010, at 27-28; and Ernst & Young, “APAC Tax Matters” May 2010 (available at www.ey.com), accessed on 29 December 2010, at 14-15.

62 An asset falling into item (1), (2) or (4) is excluded from the rollover relief if its book value immediately before the transfer is less than 10 million yen: Article 61-13(2) and Cabinet Order 122-14(1); and Yoshihiro Masui, “General Report” in International Fiscal Association, *Cahiers de Droit Fiscal International Volume 89b: Group Taxation* (2004), at 52.
The Netherlands

Under fiscal unity, intra-group transactions – including intra-group asset transfers – are ignored at group level and tax bases are rolled over.\textsuperscript{63} Any gain or loss on the transfer is deferred. If the asset is then sold to a third party outside the group, the deferred gain or loss would be recaptured. This policy is in accordance with the general principle of fiscal unity that subsidiaries are treated as part of the parent company.

The rollover policy for intra-group asset transfers is subject to abuse. Specific anti-avoidance provisions are designed to protect the integrity of the rollover policy.\textsuperscript{64}

New Zealand

In general, intra-group transactions are ignored during consolidation in New Zealand.\textsuperscript{65} Gain or loss arising from transfer of the following assets, if subject to tax, can be deferred under the rollover policy:\textsuperscript{66}

(1) depreciable assets;
(2) revenue assets;
(3) trading stock; and
(4) financial arrangements.

The deferred gain or loss is recaptured if the group subsequently sells the asset to a third party.

\textsuperscript{63} Vanistendael, above note 51, at 82.
\textsuperscript{64} For more detail of the specific anti-avoidance provisions, see Section 7.4 below.
\textsuperscript{65} Sections FM 8 & 10 ITA2007.
\textsuperscript{66} Sections FM 15 to 20 ITA2007. For a brief discussion of the special rules applicable to trading stock and financial arrangements, see Plunket & McKinley, above note 38, at 492-493.
Similar to the Netherlands, the rollover policy in New Zealand is protected by an anti-avoidance provision. In broad terms, the rollover relief is denied if (i) a company joins a consolidated group with an asset that it subsequently transfers to a group member, (ii) the company then leaves the group, and (iii) it could be reasonably concluded that the company’s action is tax driven.\(^67\)

**Spain**
Spain adopts the neutralisation policy for intra-group asset transfer. A consolidated group’s taxable income or loss is determined after intra-group transactions are eliminated.\(^68\)

If the asset is subsequently sold to a third party outside the group, the deferred gain or loss is recaptured at the group level.\(^69\) Similar to France and Italy, this provision is required under a pooling system to ensure that the full amount of gain or loss is recognised when the asset is sold outside the group.

**The United States**
As discussed in Section 7.2 above, under the U.S. consolidation regime, each group member computes its own taxable income under the separate entity doctrine. The taxable income of all group members is then combined together at the group level, subject to adjustments to reflect the enterprise doctrine.

For instance, if Company A sells an asset to Company B within the same consolidated group, A would determine its gain or loss on a separate entity basis and B would have a cost basis in the asset equal to the purchase price. The timing, character, source and other attributes of these items are then

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\(^{67}\) Section FM22 ITA2007.

\(^{68}\) Section 72 LIS.

\(^{69}\) Section 73(1) LIS.
redetermined at the group level “to produce the effect of transactions between divisions of a single corporation”. The gain or loss realised by A would be deferred until for example B sells the asset to a third party outside the consolidated group.

If depreciating assets are involved, the neutralisation policy operates in a more complicated manner. For instance, if A sells a depreciating asset to B for a gain, the gain realised by A would be deferred under consolidation. However, partial recapture of the deferred gain is triggered by the additional depreciation claimed by B. In other words, the amount of A’s deferred gain (in its own tax computation) is reduced every year by the amount of additional depreciation claimed by B (in its own tax computation).

The net result at the group level remains the same: gain or loss on the intra-group asset transfer is deferred. However, if the asset is subsequently sold to a third party outside the group, the respective amounts of gains realised by A and B are different as a result of the continuous recapture of the deferred gain in A. This could be important if the characters of the gains in A and B are different.

This policy reflects the strong influence of the separate entity doctrine in the U.S. consolidation regime. Each group member maintains to a large extent its separate entity status during consolidation. The compliance costs are high, as the group has to not only keep track of the amount of deferred gain of each

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70 Reg. 1.1502-13(a)(2).
71 The deferred gain would also be recaptured if either A or B leaves the group. See discussion in Section 7.4 below.
72 For an example of intra-group transfer of depreciating asset, see Reg. 1.1502-13(c)(7)(ii) Example 4.
73 See Example 4(e) in Reg. 1.1502-13(c)(7)(ii).
asset, but also make continuous adjustments for additional depreciation claims by the transferee.

A more consistent application of the enterprise doctrine – in the form of a rollover policy – would offer a simpler solution.\(^74\) In this case, gain on intra-group asset transfer would be deferred, with the cost base of the asset rolled over to the transferee. There would be no additional depreciation claimable by the transferee, thus it is unnecessary to continuously adjust the carried forward amount of deferred gain. However, experience in the Netherlands and New Zealand suggests that anti-avoidance provisions are often necessary to protect the rollover policy from abuse.

7.4 Leaving time: transition between the two doctrines

Leaving issues arise from the transition from the enterprise doctrine to the separate entity doctrine. The issues are complex as tax attributes of the leaving subsidiary may be a mixture of pre-consolidation attributes (for example, gains accrued during pre-consolidation period) and tax attributes generated during consolidation (for example, gains accrued during consolidation).

A leaving subsidiary may take away from the group assets that have appreciated in value during the period of consolidation. This leads to the question of whether the group should be taxed on the unrealised gain. The issue is important as it would affect the timing of taxation and also the identity of the taxpayer(s) for the gain.

\(^74\) The EC comes to the same conclusion in its consultation of CCCTB proposal: European Commission, “CCCTB: possible elements of a technical outline” (CCCTB\WP\057, CCCTB WG, 2007), paragraphs 112-115. For a numeric analysis of the two alternative policies of neutralisation and rollover applying to different classes of assets, see the annex attached to the Working Paper.
In theory, alternative policy options at leaving time include:

1. Quarantine;
2. Deemed disposal;
3. Recapture tax benefits under rollover; and
4. Rollover to the leaving subsidiary.

These policy options are analysed in detail in Appendix B with numeric examples. Below is a summary of the policy analysis of the options.

1. **Quarantine**
   Under this policy option, tax attributes generated during consolidation would be quarantined at the group level. Pre-consolidation tax attributes that remain at leaving time are treated consistently, namely being quarantined at the subsidiary level. This policy respects the transitions between the two doctrines and deals with the tax attributes accordingly. Nevertheless, though theoretically superior to the other options, the quarantine policy option has serious problems. Compliance and policing costs of tracing the asset and its market value until it is sold to a third party would be significant. The complexity of tracing assets after leaving time and the recalculation of gains attributable to different taxpayers (for example, the consolidated group and subsidiaries) is most likely to be unacceptable in practice.

2. **Deemed disposal**
   Under this policy option, assets taken away by a leaving subsidiary from a consolidated group would be deemed to have been disposed of to the subsidiary at market value at the leaving time. This policy arguably provides a clear cut transition between the two doctrines. However, it violates the
realisation principle and taxes unrealised gain at the leaving time. Corporate
groups are unlikely to welcome immediate taxation of unrealised gains.
Nevertheless, governments may prefer this option as it would be relatively
simple to administer: there would be no need to trace the asset until actual
disposal by the ex-subsidiary.

(3) **Recapture tax benefits under rollover**
Rollover relief may have been allowed during consolidation and also at
joining time. Under the recapture policy, the tax benefits allowed under the
rollover reliefs are recaptured at leaving time as the subsidiary is no longer
part of the consolidated group.

Under the enterprise doctrine, gain or loss on asset transfer should be deferred
only if the transfer is between group members. It follows that if that
relationship ceases to exist and either the transferor or transeree leaves the
group, the deferred gain or loss should be recaptured. The recapture policy
also has the advantage of avoiding tracing assets after the leaving time. The
taxation of the deferred gain at leaving time is likely to be more acceptable to
corporate groups than the deemed sale policy. Instead of deeming a sale of the
asset, the amount recaptured under this policy represents the gain realised by
an actual transfer of the asset between two group members.

(4) **Rollover to the leaving subsidiary**
This policy option provides rollover relief for the assets taken away by the
leaving subsidiary from a consolidated group. No immediate tax implications
arise at the leaving time. Gain or loss on subsequent disposal of the asset is
attributed wholly to the subsidiary. The main advantage of this policy option
is simplicity, as no tracing or valuation of the asset is required. However, it
violates the enterprise doctrine as the subsidiary is no longer in the group after
the leaving time. Furthermore, in practice the deferral of taxation time may not be acceptable to most governments.

The policies on the treatment of assets at leaving time in the consolidation regimes in the eight countries are analysed in the following section.

**Australia**

When a subsidiary leaves a consolidated group, the tax cost setting process is reversed. The tax law re-recognises the existence of the shares in the subsidiary and reconstitutes their cost base.\(^{75}\) This is again a complicated and problematic process.\(^{76}\)

Under the asset-based model, the tax law does not recognise any intra-group asset transfer during consolidation. As a result, there is no issue of recapture of any deferred capital gain at leaving time.

Another implication of the asset-based model is that a leaving subsidiary would inherit from the parent company the reset cost bases of its assets.\(^{77}\) The original actual costs of the assets are lost forever, even if the assets have always remained in the hands of the subsidiary throughout the consolidation cycle. As discussed in Section 7.2 above, the model and its tax cost setting

\(^{75}\) Section 701-15 ITAA1997.

\(^{76}\) For detailed discussion of the TCS rules at leaving time, see Appendix A Section A.2. Basically it is a "bottom up" approach which pushes up the reset cost basis of assets in the subsidiary to determine the tax basis of the shares in the subsidiary. In broad terms, the group has to compute the "allocable cost amount" for the shares through a 4-step process, then allocate that amount to the membership interests in the subsidiary: Division 711 ITAA1997. The process would have to be repeated for each level of subsidiaries in the corporate chain until the shares being sold by the group is reached. For a brief discussion of the process and the additional complication caused by MEC groups (i.e. foreign owned consolidated groups with multiple resident holding companies), see O'Donnell & Spence, above note 14, at 129 and 137.

\(^{77}\) This is one of the implications of the "exit history rule": section 701-40 ITAA1997.
rules can produce arbitrary results and create artificial gain or loss on the assets.

France
Any gain or loss of an intra-group asset transfer that has been neutralised during consolidation is recaptured upon the leaving of the transferor or the transferee company.\(^78\) The deferred gain or loss of intra-group asset transfer is recognised by the tax law as belonging to the transferor, implying that subsidiaries are still regarded to a large extent as separate entities under consolidation. In other words, the separate entity doctrine maintains significant influence to the consolidation regime.

Italy
As discussed in Section 7.3 above, neutralisation at the group level was available to intra-group asset transfer before 1 January 2008. If either the transferor or the transferee left the group, the deferred capital gain would be recaptured at the group level. On 1 January 2008, the neutralisation policy was abolished.\(^79\) This policy change represents significant departure from the enterprise doctrine.

Japan
In Japan, deferred gain or loss on intra-group asset transfer is recaptured when the transferor leaves a consolidated group.\(^80\) The trigger of recapture by the departure of the transferor only but not the transferee is uncommon. In fact, Japan is the only country among the eight countries with this policy. The

\(^{78}\) Article 223F CGI.

\(^{79}\) Bendotti, above note 60, footnote 7 at 339.

\(^{80}\) Article 61-13 CTA. For a brief discussion of the recapture rules, see Komamiya, above note 61, at 399.
majority of countries recapture deferred gain or loss at the leaving of either the transferor or the transferee.

**The Netherlands**

The rollover relief for intra-group asset transfer is subject to abuse when applied together with the participation exemption. For instance, assets with “hidden reserves” — that is, assets that have appreciated in value — could be transferred to a group company tax free under the rollover relief. Sale of shares in this company to a third party could also be tax free under the participation exemption regime. Effectively, the asset with hidden reserve could be transferred to the third party tax free.\(^81\)

To tackle this avoidance opportunity, a specific anti-avoidance provision operates to deem disposal of the asset at market value upon the leaving of either the transferor or the transferee from the consolidated group.\(^82\)

The deemed disposal rule does not apply if:\(^83\)

1. the transfer was within the normal business operations of the transferor and transferee;\(^84\)

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\(^81\) For an example of this arrangement, see Müller, above note 61, at 274.

\(^82\) Article 15ai(1) Vpb. For a brief discussion of the rules, see Müller, above note 34, at 270 & 274-277. In certain circumstances, the group may elect to mark the asset to the market value at time of intra-group transfer: Article 15ai(2). Similar to the Dutch consolidation regime, “rollovers upon both joining and leaving” is the current EC position in the proposed CCCTB regime. The proposed measure would recapture such gains by taxing the disposal of shares in the leaving subsidiary: European Commission, “CCCTB: possible elements of a technical outline” (CCCTB\WP\057, CCCTB WG, 2007), paragraph 109. This default position is also subject to a similar anti-avoidance measure, namely, if an asset has been transferred from another group member to the leaving subsidiary within two years of leaving and the transfer is not for commercial reasons, deferred gain on the asset would be recaptured effectively at time of leaving.

\(^83\) Article 15ai(3) Vpb.
(2) the transfer was in exchange for shares issued by the transferee and occurred at least 3 years before the leaving time; or
(3) the transfer occurred at least 6 years before the leaving time.

The rationale for the above exceptions is that these transfers are presumably not tax driven. In other words, the default rollovers policy is switched to "rollover plus deemed disposal" if the intra-group asset transfer is regarded as tax driven.

A company has to leave a consolidated group if it ceases to be a resident of the Netherlands. In that case, its assets are deemed to have been disposed of at their market values. This provision overrides the general deemed disposal rule upon leaving of either the transferor or the transferee. In other words, the exceptions mentioned above are not applicable in this case. It is interesting to observe that the rules are much tougher once a company becomes a non-resident, presumably due to the concern that it would become more difficult to levy tax on the hidden reserves once a taxpayer becomes a non-resident.

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84 For an example illustrating the meaning of "normal business operations", see Müller, above note 34, at 276.
85 For a discussion of the rationale behind each of the exceptions, see ibid, at 275-276. The government originally proposed the time limit to be 10 years, but subsequently decided to relax the limit to 6 years: IBFD, "Bill amending group taxation regime modified" dated 27 June 2001 TNS Online (available at www.ibfd.org), accessed on 26 October 2007.
86 Article 15c Vpb.
87 Article 15ai(6) Vpb.
88 Such deemed disposal rule is not uncommon for cessation of residence. For example, see similar deeming rule (CGT event II) in Australia: s.104-160 ITAA1997.
New Zealand

If an intra-group asset transfer has been subject to rollover relief during consolidation, the asset in general is deemed to have been disposed of at its market value when the transferee leaves the group. This policy represents a consistent application of the enterprise doctrine and respects the transition between the two doctrines. Upon the change from the enterprise doctrine to separate entity doctrine at leaving time, accrued gain or loss on the asset is recognised in the hands of the group.

The tax law includes a specific provision to deal with the situation under which the asset’s market value can not be separately identified (for example, the asset is absorbed into another asset). In this case, the disposal proceeds would be deemed to be the market value at the time of intra-group asset transfer. In other words, only the deferred gain or loss on the intra-group asset transfer is recaptured.

Spain

The consolidation regime in Spain stipulates that deferred gain or loss on intra-group transaction is recaptured at the group level if a company in the transaction leaves the consolidated group.

The United States

Deferred gain or loss on intra-group asset transfer is recaptured when either the transferor or the transferee leaves the consolidated group. In particular,

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99 Section FM 21(2) ITA2007.
90 Section FM 21(3) ITA2007.
91 Section 73(2) LIS.
92 Reg. 1.1502-13(a)(5). If the transferor leaves the group, the recapture may trigger corresponding adjustments to the cost base of shares in the transferor; see Example 1 in Reg. 1.1502-13(d)(3). This issue is discussed in more detail in the next chapter.
recapture occurs when the transferor and the transferee “cannot be taken into account to produce the effect of treating [the two entities] as divisions of a single corporation”.\textsuperscript{93}

7.5 Conclusion

The policies of the treatment of assets at joining time, during consolidation and at leaving time in the consolidation regimes of the eight countries are summarised in Table 8 below:

\textsuperscript{93} Reg. 1.1502-13(d).
### Table 8 Treatment of assets in the eight countries

<table>
<thead>
<tr>
<th>Country</th>
<th>Australia</th>
<th>France</th>
<th>Italy</th>
<th>Japan</th>
<th>Netherlands</th>
<th>NZ</th>
<th>Spain</th>
<th>US</th>
</tr>
</thead>
<tbody>
<tr>
<td>Single entity concept</td>
<td>Asset-based</td>
<td>Pooling</td>
<td>Pooling</td>
<td>Pooling</td>
<td>Fiscal unity</td>
<td>Pooling</td>
<td>Pooling</td>
<td>Pooling</td>
</tr>
<tr>
<td>Joining time</td>
<td>Reset cost base</td>
<td>n/a</td>
<td>n/a</td>
<td>Deemed sale (with exceptions)</td>
<td>Rollover (deemed sale for intra-group shares and receivables)</td>
<td>n/a</td>
<td>n/a</td>
<td>n/a</td>
</tr>
<tr>
<td>Intra-group transfer during consolidation</td>
<td>n/a</td>
<td>Neutralise</td>
<td>Immediate taxation Before 2008: neutralise (optional)</td>
<td>Neutralise</td>
<td>Rollover (with anti-avoidance rules)</td>
<td>n/a</td>
<td>Neutralise</td>
<td>Neutralise</td>
</tr>
<tr>
<td>Leaving time</td>
<td>Inherit reset cost base</td>
<td>Recapture (Transferor /transferee)</td>
<td>n/a</td>
<td>Before 2008: Recapture (Transferor /transferee)</td>
<td>Recapture (Transferor)</td>
<td>Rollover (deemed sale if tax driven)</td>
<td>n/a</td>
<td>Recapture (Transferor /transferee)</td>
</tr>
</tbody>
</table>
Six countries – namely France, Italy, Japan, New Zealand, Spain and the United States – adopt the pooling system, under which assets of a subsidiary are regarded as still being owned by the company during consolidation. It follows that all of them, except Japan, do not have tax implications on the assets at joining time. Japan has a different policy: many assets – including fixed assets – are deemed to have been sold to the consolidated group at the market value at joining time. The policy of taxing unrealised gain is harsh on corporate groups, and contradicts the policy objective of competitiveness.

All the six countries that adopt the pooling system, except New Zealand, adopt the neutralisation policy to eliminate gain or loss on intra-group asset transfers during consolidation. The gain or loss, though recognised in the individual group company’s tax computation, is neutralised at the group level when computing the group’s taxable income or loss. The policy represents a significant influence of the separate entity doctrine, as subsidiaries within a consolidated group are still regarded to a large extent as separate entities. The system is in general more complex than the alternative rollover policy, requiring more consolidation adjustments. This is especially so if deprecating assets are involved. At leaving time, all these five countries recapture any deferred gain or loss under its neutralisation policy. In four countries – namely France, Italy (before 2008), Spain and the U.S. – the recapture is triggered by the leaving of either the transferor or the transferee. In Japan, the recapture is triggered by the leaving of only the transferor.

Among the six countries that adopt the pooling system, New Zealand has a different policy on intra-group asset transfers and also at leaving time. For assets that are subject to tax in the country, it adopts the rollover policy on such transfers during consolidation. Anti-avoidance provision is required to
protect the rollover policy from abuse. At leaving time, it adopts the deemed sale policy on these assets.

The Netherlands is the only country among the eight countries that adopts consistently the rollover policy on assets at joining time, during consolidation and at leaving time. Under the rollover policy, no adjustment is required at group level for intra-group asset transfers, as any gain or loss on the transfer is ignored under consolidation. The transferee inherits the cost bases of the asset from the transferor. The continuous rollover policy in the Netherlands is beneficial to taxpayers. Any gain or loss on the intra-group asset transfer is deferred until the asset is actually sold to third parties. In general, it is simpler to operate than the neutralisation and rollover policies. However, anti-avoidance provisions are necessary to protect the rollover policy from abuse.

The asset-based model in Australia is unique, representing a bold attempt to apply the enterprise doctrine to an unprecedented level in a consolidation regime. It not only deems that the parent company owns all assets of the consolidated subsidiaries, but also resets the tax bases of those assets. The reset cost bases are determined under the complex and problematic tax cost setting rules. The asset-based model creates a taxpayer-friendly environment for corporate groups during consolidation, as intra-group asset transfers are ignored completely. There is no need to trace the movement of assets within the consolidated group, record any deferred gain or loss, or recapture them at leaving time. Instead, a leaving subsidiary inherits the reset cost bases of assets from the parent company at leaving time. However, the price to pay for these advantages is high. The tax cost setting rules are not only complex, but also based on flawed theory, if there is a theory at all. The problems are fuelled further by the implant of accounting liabilities into the TCS calculations. They can produce outcomes that are detached from reality and
defy common sense. Artificial gain can be generated through the TCS process, which can even be duplicated at leaving time. In practice, well-advised taxpayers are more likely to turn this “double trouble” into duplication of losses. The policy of allowing step-up cost bases of assets is arguably too generous, and encourages taxpayers’ creativity.

While Australia’s asset-based model allows tax free asset transfers within a consolidated group during consolidation, the rules dealing with the transitions at both the joining time and leaving time are notoriously complex, and can produce tax outcomes that violate the neutrality principle. Japan’s deemed sale policy at the joining time is possibly the simplest solution; however, it is doubtful if the policy option is acceptable to other countries with respect to the tax policy objective of competitiveness. Overall, the rollover and recapture policy seems to be the preferred solution to the key structural element of intra-group asset transfers in terms of simplicity and competitiveness.

The next chapter deals with a related key structural element of a consolidation regime: the treatment of intra-group shares. This element is analysed in a separate chapter, as the associated dual cost bases issue is one of the most difficult issues of the taxation of corporate groups. Intra-group shares often require different policy solutions from other assets of a consolidated group.
8.1 Introduction

This chapter analyses and compares the treatment of intra-group shareholdings in the consolidation regimes of the eight countries. The analysis builds on the discussion of the treatment of non-share assets in Chapter 7. Some of the issues on non-share assets and intra-group shareholdings are similar. However, the complexity of the issues on intra-group shareholdings, together with the associated dual cost bases issue, warrants a separate chapter from the analysis of the treatment of other assets.

The dual cost bases issue is one of the most difficult issues of corporate taxation. It deals with the double taxation or deduction of the same economic gain or loss through a corporate chain.\(^1\) The issue can be illustrated with the following example.

Assume that Company A establishes a wholly owned subsidiary Company B with capital of $100. Company B in turn purchases an asset for $100 in Year 1, and sells the asset for $180 in Year 2, realising a gain of $80. It retains and

does not distribute the profits to Company A. In Year 3, Company A sells all shares in Company B for $180, realising a gain of $80. The scenario is depicted in Diagram 18 below:

**Diagram 18 The dual cost bases issue**

The same economic gain of $80 is recognised first in the hands of B (as profits from the disposal of the asset), then again in the hands of A (as profits from the disposal of the shares). The actual amount of duplicated gain may be less, as income tax would be levied on B on the $80 gain.\(^3\)

\(^2\) For clarity purposes, the income tax implication on the gain is ignored in the example.

\(^3\) For example, if tax rate is 30%, tax on the gain on disposal of the asset would be $24. B would be left with $180 less $24, i.e. $156. In that case, A would sell B for $156, realising a gain of $156. Thus, the duplication would be $56, i.e. the after-tax retained profits in B. In practice, the actual amount of duplication depends on many other factors that may affect the market value of the shares. Detailed discussion of the factors and the dual cost bases issue is beyond the scope of this thesis. For a discussion of the issues and a summary of the corresponding policies in different countries, see Richard Vann, “General Report” in
It is important to recognise that the duplication issue applies equally to losses. The same economic losses may be recognised more than once in a corporate chain. In practice, duplication of losses is often a more pressing issue for governments due to tax avoidance concerns.4

A strict application of the separate entity doctrine implies that A and B, being separate taxpayers, should be taxed without taking into account any tax paid by the other entity. The $80 gain in the hands of B should be taxable for B. The $80 gain in the hands of A should be taxable to A, without reference to whether the underlying gain in B has already been subject to tax or not. This is the traditional classical system of corporate taxation.

Most of the modern corporate tax systems recognise that the dual cost bases issue does exist, and various policies have been implemented attempting to deal with the issue.5 The recognition of the dual cost bases issue represents an acceptance of the enterprise doctrine. Under the doctrine, the original gain of $80 from the disposal of the asset is regarded as having already been taxed in the hands of the group (composed of A and B). Taxing the gain a second time in the hands of the same group would be inappropriate. This is true particularly under a consolidation regime, as the whole group is treated as one single taxpayer.


4 For instance, Australia has introduced complex regimes to deal with duplication of losses but not for gains: Subdivisions 165-CC & 165-CD ITAA1997.

5 For example, see Hugh J Ault and Brian J Arnold, Comparative Income Taxation: A Structural Analysis (3rd ed, 2010, Kluwer, Alphen aan den Rijn), at 358-362. Attempts to deal with the issue in the context of unrealised gain or loss in assets have proved to be particularly complex. For example, see Subdivisions 165-CC and 165-CD ITAA1997 for the Australian rules to deal with multiplication of unrealised losses.
One of the possible policies to deal with the dual cost bases issue is the participation exemption ("PEX") regime. By exempting dividends and gains derived from shares, the regime effectively removes one of the two levels of taxation that causes the dual cost bases issue. The regime therefore deals directly with the primary cause of the issue and comprehensively resolves it. Another advantage of the PEX regime is neutrality: it is generally applicable to intra-corporate shareholdings for both consolidated and unconsolidated groups. It may also apply equally to resident and non-resident shareholders.

In contrast, other policies, such as the asset-based model in Australia, in general do not apply outside consolidation regimes.

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6 In the CCCTB project in the EU, the EC is more concerned about another problem: no taxation at all. Under the current CCCTB proposal, sale of shares in a subsidiary may be exempt under participation exemption rules. It is proposed that gains on disposal of non-portfolio shareholdings by a group to entities both within and outside the bloc would be exempt: European Commission, "CCCTB: possible elements of a technical outline" (CCCTB\WP\057, CCCTB WG, 2007) ("CCCTB WP57"), paragraph 126. The EC experts are, not surprisingly, divided on the issue. Some prefer simplicity and argue for a blanket full participation exemption regardless of any underlying unrealised gains in the assets: European Commission, "An overview of the main issues that emerged at the third meeting of the subgroup on group taxation" (CCCTB\WP\053, CCCTB WG, 2007) ("CCCTB WP53"), paragraph 43. The EC is not keen on this option, as it "would ... plainly be open to abuse as assets could easily be transferred into a company and the shares sold": CCCTB WP57, paragraph 109. The tax benefit may be substantial and, possibly more importantly, the issue is politically sensitive. The countries that can collect tax on the realised gain under the CCCTB regime would likely be different from those that can collect tax on the actual gain from a subsequent asset disposal. Other EC experts are more concerned about avoidance opportunities and argue that the sale of shares should be deemed to be a sale of the underlying assets: CCCTB WP53, paragraph 43. These experts argue that the policy is "consistent with the idea of treating a CCCTB group as if it were a single entity and the sale of an entity should be treated in the same way as the sale of an asset". The EC seems to be reluctant to adopt this policy and suggests that "some might consider ... that this [policy] pushes the logic too far" (emphasis added): CCCTB WP57, paragraph 108. Having dismissed both suggestions as "extreme", the EC proposes an "intermediate solution": the participation exemption would not apply to the extent that "assets were transferred to the departing company within the present or previous tax year [without valid commercial reasons] and their disposal would have triggered a gain ...": ibid, paragraphs 108-109. Some experts further suggest that for anti-avoidance purposes the two-year period should be extended, particularly for intangible assets: European Commission, "Summary record of the meeting of the common consolidated corporate tax base working group" (CCCTB\WP\059, CCCTB WG, 2007), paragraph 43.
Other countries without a PEX regime have adopted different and often more complicated policies to deal with the dual cost bases issue. For instance, Australia adopts the asset-based model in its consolidation regime which effectively collapses multiple levels of shareholdings into one, thus removing the dual cost bases issue. The United States adopts the equity-based model under which adjustments to cost bases of shares are made continuously in a consolidated group to remove duplication of income or deductions.

The policies of the treatment of intra-group shareholdings at joining time, during consolidation and at leaving time in the consolidation regimes of the eight countries are analysed in the following material.

8.2 Joining time: transition between the two doctrines
As discussed in Chapter 7, the basic problem at joining time is how the tax attributes of assets in a joining subsidiary should be treated at the transition from the separate entity doctrine to the enterprise doctrine. In the context of intra-group shareholdings, pre-consolidation tax attributes include their tax cost bases, and unrealised gain or loss accrued in the shares.

Australia
As discussed in Section 7.2 in Chapter 7, Australia developed the world’s first asset-based model to deal with the dual cost bases issue in its consolidation regime. Under the model, multiple levels of shareholdings are deemed to have collapsed into one level upon consolidation, thus removing the dual cost bases issue for a consolidated group.

In order to achieve the "deemed disappearance" of the shares in the subsidiary, the tax cost setting ("TCS") rules in broad terms operate to push the cost bases of shares – together with various adjustments including accounting liabilities in the subsidiary – down to the underlying assets.\(^8\) The effect is that at joining time, the original costs of shares in the subsidiary become irrelevant for income tax purposes.

A major advantage of the asset-based model is that "there are no tax compliance requirements for inter-entity transfers of assets within consolidated groups".\(^9\) Assets of a consolidated subsidiary are deemed to be owned directly by the parent company during consolidation. Intra-group transfer of the asset is regarded as transfer within the parent company itself. There is no need to trace movement of assets within the group, track any deferred gain or loss on the intra-group asset transfer, or recapture the gain or loss at the leaving time.

However, as analysed in the previous chapter, the price to pay for the advantage is high. The TCS rules are complex and problematic, and can produce artificial gain or loss.\(^10\) In summary, at joining time, the original cost bases of shares in a joining subsidiary are lost forever.\(^11\) The shares will

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\(^8\) The objective of the tax cost setting rules for joining subsidiary is "to recognise the cost to the head company of such assets [of the subsidiary] as an amount reflecting the group's cost of acquiring the entity": s.701-10(3) ITAA1997. In the government's words, "the group's cost of membership interests is stored in its cost of assets": EM to May 2002 Consolidation Act, paragraph 5.108.


\(^10\) The TCS rules for MEC groups are different, and stretch the logic of the rules even further. See Appendix A Section A.3 for more detail.

\(^11\) Besides the cost bases, an important tax attribute – the pre-CGT status – of shares in a joining subsidiary is also subject to a similar process, and may be lost through the
receive a "reconstituted" cost base at leaving time, depending on, among other things, the cost bases of assets that the company takes away from the group. The issues at leaving time are discussed in Section 8.4 below.

France

The domestic consolidation regime in France is a pooling system. Each subsidiary remains to a large extent as a separate entity from the parent company in a consolidated group, and still has to compute its own taxable income or loss. The consolidated group’s taxable income or loss is determined by aggregating the taxable income and losses of all group members, subject to certain adjustments at the group level. It follows that, similar to the treatment of other non-share assets, there is no tax implication for intra-group shareholdings when a subsidiary joins a consolidated group.

Italy

Similar to France, Italy operates a pooling system under its domestic consolidation regime. There is no tax implication for intra-group shareholding at joining time.

Japan

The consolidation regime in Japan is also a pooling system. However, as discussed in the previous chapter, it has a different policy on certain assets of a joining subsidiary from other countries with a pooling system. In particular, shares held by a joining subsidiary in general are marked-to-market at the consolidation cycle. However, as the policy of pre-CGT status is uncommon in other countries, detailed discussion of the issue is beyond the scope of this thesis.

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12 Article 223B CGI.
13 Article 118(1) TUIR.
14 Article 61-11 CTA. For more detail of the deemed sale policy, see discussion in Chapter 7 Section 7.2.
joining time. Accrued gain on the shares is crystallised upon consolidation and taxable in the hands of the joining subsidiary. If the marked-to-market rule results in a loss, the loss is treated as pre-consolidated losses of the joining subsidiary, which are extinguished upon joining a consolidated group.\(^\text{15}\)

Exceptions to the general "deemed sale" policy include:

1. accrued gain or loss of the shares is less than 50 per cent of the capital of the subsidiary or ten million yen; and
2. subsidiary owned by the parent company for at least five years.

The deemed sale policy arguably reflects a clear transition from the separate entity doctrine to the enterprise doctrine. However, the policy implies high compliance costs for the valuation exercise at joining time and renders the consolidation regime less attractive to taxpayers.

**The Netherlands**

The consolidation regime in the Netherlands, known as the fiscal unity regime, represents a stronger application of the enterprise doctrine than the pooling system. Activities, assets and liabilities of a subsidiary are deemed to be those of the parent company.\(^\text{16}\)

The general rule on assets under the fiscal unity regime – namely, the rollover policy for accrued gain or loss on assets of the subsidiaries – does not apply to

\(^{15}\) KPMG, "Taxation in Japan 2008" (available at www.kmpg.or.jp/resources/research/), accessed on 11 February 2009, paragraph 1.11. The issue of pre-consolidation losses is discussed in Chapter 6 Section 6.2.1.

\(^{16}\) Article 15(1) Vpb.
intra-group shareholdings. Instead, shares held by the parent company (and other group members, if applicable) in a joining subsidiary are marked to market at joining time. In other words, the Netherlands adopts the “deemed sale” policy on intra-group shareholdings, crystallising any unrealised gain or loss in the shares at joining time. The gain may be exempt from taxation if the shares qualify for the PEX regime.

The objective of the deemed sale policy is to prevent otherwise taxable gain on the shares from escaping taxation through consolidation. Without the deemed sale policy, unrealised gain on shareholdings that do not qualify for PEX may escape taxation. For example, assume a parent company originally owns only 4 per cent in a company and subsequently acquires all remaining shares and consolidates the subsidiary. The PEX regime in the Netherlands requires a minimum holding of 5 per cent; the 4 per cent shareholding therefore should not be eligible for the participation exemption. The “marked-to-market” rule ensures that any accrued gain on the 4 per cent shareholding is taxed at the joining time.

This example illustrates that the deemed sale policy is basically an anti-avoidance provision to protect the PEX regime. If the parent company has always held more than 5 per cent in a joining subsidiary, any crystallised gain on the shares under the deemed sale policy would be exempt under PEX. In

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17 Another exception is intra-group receivables, which in general are required to be marked to market at the joining time, resulting in immediate taxation of accrued gain: Article 15ab(6) Vpb. For an example of this situation, see Johann Müller, The Netherlands in International Tax Planning (2005), at 253.

18 Article 15ab(1) Vpb.

19 The following example is based on the example in Müller, above note 17, at 253.

20 The PEX regime in the Netherlands is discussed in more detail in Section 8.3 below.

21 Under the PEX regime, in general gains accrued during the period of less than 5% shareholding would not be eligible for exemption: Müller, above note 17, at 209-210.
other words, provided the parent company's shareholding in the joining subsidiary has always been at least 5 per cent, there would not be any tax implications for intra-group shareholdings at joining time.

**New Zealand**

In general, gain or loss on shares held as capital assets is not subject to tax in New Zealand. Furthermore, the consolidation regime in New Zealand is a pooling system. It follows that there is no specific tax implication for shares of a joining subsidiary at joining time.

**Spain**

The consolidation regime in Spain is also a pooling system. Subsidiaries remain to a large extent separate entities from the parent company. It follows that there is no tax implication for the intra-group shareholding at joining time.

**The United States**

The consolidation regime in the U.S. is also a pooling system. There is no specific tax implication for shares in a subsidiary at the joining time. Their cost bases at the joining time are determined according to the general basis rules. However, the cost bases are subject to adjustments throughout the period of consolidation. The adjustment rules are discussed in more detail in


24 For example, the group's profit of loss is determined basically by adding together the profits and losses of individual group members, subject to certain adjustments (e.g. intra-group transactions): Section 71 LIS.

Chapter 8 Treatment of Intra-group Shareholdings

Section 8.3 below.

In summary, all the eight countries, except Australia and the Netherlands, adopt the same policies for intra-group shareholdings as for other non-share assets of a subsidiary at joining time. Australia deems shares in a joining subsidiary to have disappeared upon consolidation. The Netherlands adopts the deemed sale policy on shareholdings in a joining subsidiary. Together with its PEX regime, the net effect in general is a tax free transition into consolidation at the joining time, unless some of the shares do not qualify for PEX.

8.3 During consolidation: intra-group share transfer

Under the enterprise doctrine, intra-group asset transfer should have no tax implication for the group. The transfer should be treated as if it is a transfer between divisions of a company. This policy should apply equally to intra-group shareholdings. This is the case in a majority of the eight countries. Some countries adopt a different policy for intra-group shareholdings primarily to deal with the dual cost bases issue.

The policies of intra-group share transfer during consolidation in the eight countries are analysed in the following paragraphs.

Australia

Under the asset-based model, intra-group shares in a consolidated group are deemed to have disappeared. It follows that intra-group share transfer during consolidation has no tax implications in Australia.

France

Discussion of the treatment of intra-group shareholdings in a consolidated
group in France requires an understanding of its PEX regime.\textsuperscript{26}

The PEX regime in France applies to dividends from both resident and non-resident companies.\textsuperscript{27} The exemption regime has been extended to cover capital gains on qualifying participations since 1 January 2007.\textsuperscript{28} The conditions for PEX to apply include, among other things:\textsuperscript{29}

1. the parent company is subject to corporate income tax at the normal rate on all or part of its activities;

2. the parent company must hold at least five per cent of voting share capital in the subsidiary; and

3. the parent company undertakes to hold the shares for at least two years.\textsuperscript{30}

The exemption in general applies to only 95 per cent of the dividend and


\textsuperscript{27} IBFD, “Country Analysis - France - Corporate Taxation (online database)” (available at www.ibfd.org), accessed on 28 December 2010, paragraph 6.1.3.

\textsuperscript{28} Article 219 I-a quinques CGI. See also IBFD, “Country Analysis - France - Corporate Taxation (online database)” (available at www.ibfd.org), accessed on 28 December 2010, paragraph 1.7.5. Before 2007, capital gains on disposal of participation shares were subject to a reduced corporate tax rate of 8%: IBFD, “Europe - Corporate Taxation - Country Analysis - France (online database)” (available at www.ibfd.org), accessed on 23 October 2007, paragraph A.2.6.2.1.

\textsuperscript{29} Article 145 CGI.

\textsuperscript{30} The exemption applies to newly acquired shares on a provisional basis. If the parent company subsequently fails to hold the shares for at least 2 years, the exemption is recaptured plus interest charges: Article 145(1)(c) CGI.
capital gains. The remaining five per cent is taxable, which is deemed to be the corresponding expenses on the income. However, if the parent company can substantiate that the actual expenses are less than the five per cent deemed amount, the exclusion from the exemption is limited to the actual expense amount.  

The consolidation regime in France in general requires a minimum shareholding of 95 per cent. The PEX regime should therefore apply to intra-group shareholdings within a consolidated group. In general, 95 per cent of the intra-group dividends would be exempt. The remaining five per cent would be taxable at the group level.

However, the PEX regime for capital gains does not apply to a consolidated group, as the consolidated regime provides a more favourable treatment. The whole amount of capital gains on intra-group share transfers are subject to the same "neutralisation" policy that in general is applicable to intra-group transfer of other non-share assets. In particular, both transferor and transferee still account for the transfer in their individual tax computations. The gain or loss on the transfer is then neutralised at the group level. The gain or loss is deferred until either the shares are subsequently sold to third party outside the group, or either transferor or transferee leaves the group. Upon the recapture of the deferred gain, the PEX regime comes into play. If the conditions of the PEX regime are satisfied, in general 95 per cent of the gain is exempt from tax.

31 Article 216 CGI. This is in accordance with the EC Parent-Subsidiary Directive, which provides that each Member State may disallow related expenses to distributions from subsidiary, in general up to a maximum of five per cent of the distribution: Article 4(2).

32 For discussion of the membership requirements under the French consolidation regime, see Chapter 5 Section 5.5.

33 Article 223F CGI.
The combined operation of the consolidation and PEX regimes provides a working example of how to apply the enterprise doctrine while at the same time effectively dealing with the dual cost bases issue. Intra-group share transfer is tax neutral under consolidation, implying treating the group as one single entity. The dual cost bases issue is effectively resolved by removing one of the two levels of taxation, namely by exempting the disposal gains on the shares.

This model is simple, as compared to the policies in other countries without a PEX regime (for example, the asset-based model in Australia and the equity-based model in the U.S.). The PEX regime is also neutral: it applies to both consolidated and un-consolidated groups, and also to shareholdings in both resident and non-resident companies.

**Italy**

Similar to France, Italy has a PEX regime that in general exempts 95 per cent of dividends and capital gains from qualifying inter-company shareholdings. The remaining five per cent is deemed to be the corresponding expenses in relation to the shareholdings.

The PEX regime applies to dividends paid by a resident company to another resident company. The conditions for the exemption of capital gains are

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34 The PEX regime was introduced in 2004, replacing the imputation credit system: Francesco Leone and Emiliano Zanotti, “Italian Domestic Tax Consolidation: New Opportunities for Tax Planning” (2005) 45(5) European Taxation 187, at 193. The objective of the PEX regime is to avoid double taxation of intercompany profits: OECD, Tax Policy Development in Denmark, Italy, the Slovak Republic and Turkey (available at www.oecd.org), accessed on 24 November 2007, paragraph 2.3.2(20).

35 Leone & Zanotti, ibid, footnote 37 at 193.

36 Article 89 TUIR.
different. The PEX regime applies to capital gains derived by a company if, among other things:\(^{37}\)

1. the participation has been held continuously for twelve months before the disposal;
2. the subsidiary is a resident of a country included in the white list of for CFC purposes for the last three years before the disposal;
3. the subsidiary must perform active business activities for the last three years before the disposal, unless it is a listed company; and
4. the participation is accounted for as a long-term investment.

An unusual feature of the Italian PEX regime is that there is no minimum shareholding threshold requirement. In other words, the regime does not distinguish between portfolio and non-portfolio corporate shareholders.

Before 2008, intra-group dividends within a consolidated group were fully exempt from corporate income tax. This was more generous than the general PEX regime, under which only 95 per cent of dividends is exempt from corporate income tax. However, since 1 January 2008, instead of full exemption, only 95 per cent of intra-group dividends are exempt.\(^{38}\) The treatment of inter-company dividends is now the same for both consolidated and un-consolidated groups.

With respect to intra-group share transfers within a consolidated group, there is no specific rule under the consolidation regime. Instead, the transfers would

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\(^{37}\) Article 87 TUIR and IBFD, “Country Analysis - Italy - Corporate Taxation (online database)” (available at www.ibfd.org), accessed on 28 December 2010, paragraph 1.7.5.

be subject to the general PEX regime. In particular, 95 per cent of the capital gains are exempt if the conditions for exemption of capital gains under the PEX regime are satisfied.\(^{39}\)

In summary, Italy’s consolidation regime does not provide any additional tax benefits to corporate groups in respect of intra-group shareholdings. The PEX regime is capable of providing equivalent “enterprise doctrine” treatment to dividends and capital gains in respect of intra-group shareholdings, while at the same time dealing effectively with the dual cost bases issue.

\textit{Japan}

In Japan, gain or loss on intra-group share transfer within a consolidated group is neutralised at the group level and is deferred until either the share is sold to a third party outside the group or the transferor leaves the group.\(^{40}\) This policy is similar to that for other non-share assets as discussed in the previous chapter.

Under the 2010 tax reform, since 1 October 2010, the scope of the deferral policy is expanded to cover share transfers between “100% domestic group companies”, which refer to resident companies wholly-owned by a resident company, a non-resident company or an individual.\(^{41}\) This new group taxation regime effectively removes the dual cost bases issue from both consolidated

\(^{39}\) The exemption percentage for capital gains has been quite volatile. It was 91% before 2007, reduced to 84% in 2007 and increased to 95% since 2008: IBFD, “Europe - Corporate Taxation - Country Analysis - Italy (online database)” (available at www.ibfd.org), accessed on 29 September 2007, paragraph 2.10.5.


Chapter 8 Treatment of Intra-group Shareholdings

and non-consolidated wholly-owned domestic corporate groups in Japan.

In general, dividends between resident companies are fully exempt provided that the inter-company shareholding is at least 25 per cent.\textsuperscript{42} Related interest expenses are not deductible.\textsuperscript{43} These preferential treatments on dividends are subject to a specific anti-avoidance provision targeting short-term holdings.\textsuperscript{44} The 2010 tax reform again introduced a more preferential treatment for “100% domestic group companies”. Dividends received from a “100% domestic group company” is fully excluded from taxable income without any corresponding disallowance of the interest expenses.\textsuperscript{45} This treatment is consistent with the current rules for dividends between consolidated group members, and is applicable to both consolidated and non-consolidated groups for dividends declared on or after 1 April 2010.\textsuperscript{46}

\textit{The Netherlands}

Similar to France and Italy, the Netherlands has a general PEX regime that applies equally to both consolidated and non-consolidated corporate groups.

The Dutch PEX regime has been described as “for many years [being] as

\textsuperscript{42}Article 23(1) CTA. For shareholdings less than 25%, half of the dividends are in general exempt from corporation income tax: Article 23(1) CTA.

\textsuperscript{43}Article 23(4) CTA.

\textsuperscript{44}In broad terms, the exemptions would not apply if the shares were acquired within one month of the dividend payments and sold within two months thereafter: Article 23(3) CTA. There is also an anti-avoidance provision targeting manipulated transactions of consolidated group. In broad terms, the tax office may adjust the group’s taxable income if the group’s tax liability is improperly decreased, including due to intra-group transfer of assets: Article 132-3 CTA.

\textsuperscript{45}IBFD, “Country Analysis - Japan - Corporate Taxation (online database)” (available at www.ibfd.org), accessed on 28 December 2010, paragraphs 6.1.3.

\textsuperscript{46}PwC, \textit{Asia Pacific Tax Notes} (June 2010) Issue 23 (available at www.pwccn.com), accessed on 29 December 2010, at 28; and Ernst & Young, \textit{APAC Tax Matters}, May 2010 (available at www.ey.com), accessed on 29 December 2010, at 15.
much of an export product as tulips and Gouda cheese".\textsuperscript{47} The regime indeed has a long history. The participation exemption concept for dividends was introduced in the Netherlands in 1893, and incorporated into the corporate income tax legislation in 1942. The exemption was extended to capital gains in 1969 and to certain foreign exchange gains in 1997.\textsuperscript{48}

The objective of the PEX regime is to avoid double taxation of the subsidiary’s profits, and thus "embodies a pursuit of neutrality, ensuring optimum freedom for companies with regard to the conception of their legal (group) structure".\textsuperscript{49} Under the regime, dividends and capital gains and losses on qualifying participations in general are fully exempt from corporate income tax.\textsuperscript{50} Related costs are deductible, except for costs of acquisition and disposal of the participation.

Requirements of the PEX regime include, among other things:\textsuperscript{51}

\begin{enumerate}
\item the parent company is a resident company in the Netherlands, or a non-resident company with a PE in the Netherlands;
\item the "ownership test": the parent company must hold at least five per
\end{enumerate}

\textsuperscript{47} Müller, above note 17, at 175. For a detailed discussion of the regime, see: ibid, Chapter 9.


\textsuperscript{50} Article 13 Vpb.

\textsuperscript{51} For more detail of the requirements, see IBFD, "Country Analysis - The Netherlands - Corporate Taxation (online database)" (available at www.ibfd.org), accessed on 28 December 2010, paragraph 6.1.3. There are a number of exceptions to the rules. For example, the PEX regime does not apply to parent companies that qualify as portfolio investment funds. Detailed discussion of the PEX rules is beyond the scope of the thesis. For a brief discussion of the exceptions, see Vegt, above note 49, at 369-371.
cent of the paid-up share capital in a company;
(3) the “motive test”: the participation is not held as a portfolio investment;
(4) if the motive test is not satisfied, the participation exemption can still applies if the asset test or the “subject to tax” test is met. The asset test requires that the participation is not “low-taxed investments participations”, which means participation in a company that has more than 50 per cent of the values of its assets being “free portfolio investments”. The “subject to tax test” is met if the subsidiary is taxed at a rate not less than ten per cent in its country of residence.

Unlike France and Italy, there is no minimum holding period requirement under the Dutch PEX regime.

As the PEX regime provides full exemption to intra-group share transfers, it is not necessary for the consolidation regime to have additional rules on those transfers. In other words, the PEX regime achieves the intended effect of the enterprise doctrine on consolidated groups.

**New Zealand**

As discussed in Section 8.2 above, transfer of shares that are held as capital assets is not subject to tax in New Zealand. For shares that are held as revenue assets, gain on their disposal is taxable, but subject to the rollover policy.\(^5^3\)

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\(^{52}\) Participation held by a subsidiary company of less than five per cent is deemed to be portfolio investment for the purpose: Article 13(12) Vpb. Portfolio investments are regarded as “free” if they are not necessary for the business of the company: Article 13(10) Vpb.

\(^{53}\) For more discussion of the rollover policy, see discussion in Chapter 7 Section 7.3.


**Spain**

In Spain, intra-group transactions during consolidation are in general neutralised at the group level.\(^{54}\) Intra-group transfer of shares is subject to the same treatment. The deferred gain or loss on intra-group share transfers is recaptured if either the transferor or the transferee leaves the group, and is subject to the PEX regime.\(^{55}\)

The conditions of the PEX regime include, among other things:\(^{56}\)

1. a resident company holds at least five per cent of capital in another resident company; and
2. the shares have been held continuously for the past year.\(^{57}\)

If the conditions are satisfied, the PEX regime operates to provide a tax credit to offset against tax liability arising from the participation.\(^{58}\) For dividend income, the tax credit is equal to the full tax liability on the dividends.\(^{59}\) For capital gains arising from the participation, the tax credit is in general limited to the tax liability corresponding any net increase of retained profits in the

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\(^{54}\) Section 72 LIS.

\(^{55}\) Section 73(2) LIS.

\(^{56}\) Section 30 LIS.

\(^{57}\) The PEX would provisionally apply if the shares are to be held for a year.

\(^{58}\) The regime was introduced in 1995 with the objective to avoid double taxation within a corporate chain: Emilio Cencerrado Millan, “Spain” in Guglielmo Maisto (ed), *International and EC Tax Aspects of Groups of Companies*, EC and International Tax Law Series (2008, IBFD, Amsterdam), at 453. Any excess tax credit can be carried forward for seven years: s.30(6) LIS. Effective 1 January 2011, the tax credit in respect of dividends derived is also applicable in case of shareholdings of five per cent that have been reduced to at least three per cent due to transactions that qualify for the special tax regime for corporate restructures: IBFD, “Country Analysis - Spain - Corporate Taxation (online database)” (available at www.ibfd.org), accessed on 28 December 2010, paragraph 6.1.3.

\(^{59}\) Section 30(2) LIS. For other dividends paid by a resident company to another resident company, 50% tax credit is allowed under the PEX regime: Section 30(1) LIS.
subsidiary. In other words, capital gains attributable to say goodwill would not be exempt from tax.

The United States

During consolidation, intra-group transactions — including intra-group share transfers — are in general neutralised in the U.S. At the same time, the dual cost bases issue is dealt with under the “equity-based model”. The model provides for “investment adjustments” under which the cost bases of shares in a subsidiary is adjusted for various items, including distributions, profits and losses of the subsidiary.

For example, assume that a parent company (P) acquires a subsidiary (S) for $100 and then forms a consolidated group. If S has taxable income of $10, that amount is included in the group’s consolidated taxable income and subject to tax at the group level. The “investment adjustment” rules adjust the cost base of S’s shares to $110. If P subsequently sells S, the $10 taxable income is not taxed again.

The investment adjustment rules are complex and require continuous

60 Section 30(5) LIS.
61 IBFD, “Europe - Corporate Taxation - Country Analysis - Spain (online database)” (available at www.ibfd.org), accessed on 25 April 2009, paragraph 9.4. This limit is consistent with the objective of the PEX regime to avoid double taxation of profits of the subsidiary.
63 The rules, contained in Reg. 1.1502-32, are complex. Detailed discussion of the rules is beyond the scope of this thesis. For more information about the rules, see Hennessey, above note 25, Chapter 13.
64 This is based on the example provided in Reg. 1.1502-32(a)(1).
adjustments throughout consolidation.\(^{65}\) The rules have to be applied on a “bottom-up” approach if multiple levels of shareholdings are involved.\(^ {66}\) If a company has more than one class of shares, the adjustment rules are more complicated.\(^ {67}\)

The investment adjustments may result in “negative” basis, if the downward adjustments are more than the cost base. In that case, the negative amount is captured in the parent company’s “excess loss account”.\(^ {68}\) If the shares are sold, the amount in the excess loss account is taxable as additional gain on the disposal.\(^ {69}\)

Compared with the asset-based model of Australia, the equity-based model may be equally complex. The difference is in the timing: the investment adjustments have to be made continuously during consolidation in the U.S. while the complex TCS calculations in Australia inflict the pain at the joining and leaving time.

8.4 Leaving time: transition between the two doctrines

Leaving issues arise as the application of enterprise doctrine is transited back to the separate entity doctrine. Tax attributes that have been deferred during consolidation have to been dealt with at the leaving time. Intra-group

\(^{65}\) In particular, the adjustments have to be made “as of the close of each consolidated return year, and as of any other time ... if a determination at that time is necessary to determine a tax liability of any person”: Reg. 1.1502-32(b)(1).


\(^{67}\) Reg. 1.1502-32(c).

\(^{68}\) Reg. 1.1502-32(a)(3)(ii)

\(^{69}\) Reg. 1.1502-19(b). The rules seem more reasonable than the Australian model. For example, if the ACA calculation results in a negative figure, the ACA is deemed to be zero: section 705-60 Step 8. It is unclear why the ACA can not be a negative figure.
shareholdings present more problems as the dual cost bases issue implies that special policies are required to prevent double taxation of profits (or double deduction of losses) of the leaving subsidiary.

**Australia**

When a subsidiary leaves consolidation, shares in the company – that have been deemed to have “disappeared” during consolidation – spring back to life. As discussed in Section 8.2 above, under the asset-based model the strong single entity rule, driven by the determination to deal with the dual cost bases issue during consolidation, implies that the original cost base of shares becomes irrelevant at joining time and is replaced by a reconstituted cost base at leaving time.

The TCS rules at leaving time operate with the following objective (emphasis added):  

> ... to *preserve the alignment* of the head company’s costs for membership interests in entities and their assets that is established when entities become subsidiary members.

A detailed discussion of the TCS rules at leaving time is beyond the scope of this thesis. In broad terms, the cost bases of shares in a leaving subsidiary are reconstructed by pushing up the cost bases of assets (including reset cost bases) of the subsidiary, less its liabilities.

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70 Section 711-5(2) ITAA1997.
71 For more detail of the rules, see Appendix A Section A.2.
72 Section 711-5(3) ITAA1997. The TCS steps for leaving subsidiaries are conveniently depicted in the ATO’s Consolidation Reference Manual at C2-1-060 page 3, which is reproduced in Appendix A Section A.2.
The TCS rules at leaving time have a number of major problems. First, the TCS regime represents a “road of no return” for the original cost bases of shares in a subsidiary. The “real” cost bases are lost forever and replaced by the artificially reconstituted “reset” cost bases. Second, by going through the consolidation cycle, artificial gain not only can be created, but also duplicated. Third, the TCS process at leaving time is complex. If multiple levels of subsidiaries leave a consolidated group, the TCS calculation has to be performed for each level on a “bottom-up” basis. The implant of accounting liabilities in the calculation introduces additional complexity and adjustments. Fourth, although the primary objective of the asset-based model is to eliminate the dual cost bases issue, the TCS rules fail to achieve the objective if a subsidiary leaves the group with an appreciated asset. This is because any hidden reserve in the asset would be recognised twice: first in the gain on disposal of the shares in the subsidiary, and again when the subsidiary sells the asset. In other words, the model fails to eliminate the dual cost bases issue comprehensively.

Asset-based model: a good choice?
The effects of a subsidiary going through the Australian consolidation cycle can be depicted in Diagram 19 below:
Australia chose the world-first asset-based model over the equity-based model primarily based on U.S. tax officials’ advice of their difficult experience with the latter. It appears that it was a choice between two evils. The asset-based model inflicts the pain primarily at the two transition points between the enterprise and separate entity doctrines. The corresponding relief is that intra-group asset-transfers during consolidation do not require adjustments of the cost base of membership interests. In contrast, the equity-based model inflicts the pain continuously during consolidation when complex adjustments are made to the cost base of shares in a subsidiary. Its relief is the relatively

73 Lehmann, above note 7, at 277.
straightforward transition to and from consolidation, without the need for market valuations and the complex and problematic TCS rules.

The TCS regime erases the original “real” cost bases of assets of and shares in a subsidiary. The reset cost bases can generate, and even duplicate, artificial gain or loss. The heavy reliance of the TCS regime on market valuations of assets implies high compliance and policing costs, and ample opportunities for tax avoidance. The incentive to exercise taxpayers’ creativity is boosted by the policy of allowing a step-up cost base under the reset cost base rules.

Remembering the main driving force behind the strong SER is the desire to resolve the dual cost bases issue, it is important to note that the asset-based model achieves the goal only during consolidation. The dual cost bases issue re-emerges again at leaving time. Furthermore, the asset-based model can resolve the issue only for consolidated groups, but not un-consolidated groups. In this respect, a general participation exemption regime seems to be a more comprehensive and simpler solution.

**France**

As discussed in Section 8.3 above, if a consolidated group sells a subsidiary to a third party, the PEX regime in general applies to exempt 95 per cent of capital gain on the disposal.

If the leaving company has been either the transferor or transferee of an intra-group share transfer during consolidation, any deferred gain or loss under the neutralisation policy is recaptured at the leaving time. The recapture is subject to the PEX regime, under which 95 per cent of the deferred gain is exempt.
Italy
The general PEX regime in Italy applies to consolidated groups in the same way as it applies to other groups. If gains on the sale of a consolidated subsidiary to a third party are eligible for PEX, 95 per cent of the gain is exempt from tax.

Intra-group share transfers during consolidation are also subject to the general PEX regime. It follows that there is no deferral of gain or loss on those transfers, and thus recapture is a non-issue at the leaving time.

Japan
When the shares of a consolidated subsidiary are sold to a third party, their cost base is adjusted to reflect the net change of retained profits in the subsidiary. The objective of the adjustment is to prevent double taxation of taxable income or double deduction of losses of the subsidiary.

If gain or loss on intra-group share transfer has been deferred, the deferred gain or loss is recaptured upon the transferor leaving the consolidated group. This policy is the same as that for other non-share assets as discussed in the previous chapter.

The Netherlands
The PEX regime in the Netherlands in general provides full exemption of gains on disposal of intra-group shares. There is generally no tax implication

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75 Article 61-13 CTA. For a brief discussion of the recapture rules, see Komamiya, ibid, at 399.
when a subsidiary is sold to a third party outside a consolidated group.\textsuperscript{76}

Similar to Italy, as intra-group share transfers during consolidation are in general exempt under the PEX regime, there is no tax implication arising from those transfers at leaving time.

Specific anti-avoidance provision exists to tackle abuse of the PEX regime with respect to intra-group asset transfers within a consolidated group.\textsuperscript{77}

\textit{New Zealand}

Transfers of intra-group shareholdings in general are not subject to tax.\textsuperscript{78} In the rare situation that shares are held as revenue assets, sales of the shares to a third party is taxable to the group. Furthermore, if an intra-group share transfer has been subject to rollover relief during consolidation, the shares in general are deemed to have been disposed of at the market value when the transferee leaves the group.\textsuperscript{79}

Shares in a subsidiary held as revenue assets are subject to a specific anti-avoidance provision. The objective of the provision is to prevent value shifting between group companies within a consolidated group before a subsidiary is sold to a third party.\textsuperscript{80} In broad terms, if the value of a leaving subsidiary has been reduced as a result of certain intra-group transactions

\textsuperscript{76} Technically, in order to ensure that the PEX regime can apply, the disposal is deemed to take place after deconsolidation of the subsidiary. This is required under fiscal unity, as the subsidiary is deemed as having been “dissolved” into the parent company: Müller, above note 17, at 270.

\textsuperscript{77} Article 15ai Vpb. For detail of the anti-avoidance provision, see Chapter 7 Section 7.4.

\textsuperscript{78} Transfer of shares held as capital asset is not subject to tax: Plunket & McKinley, above note 22, at 498.

\textsuperscript{79} Section FM 21(2) ITA2007.

\textsuperscript{80} Plunket & McKinley, above note 22, at 493.
(including dividend distribution and transfer of assets) during consolidation, the sales proceeds from the disposal of the leaving subsidiary are adjusted to an arm’s length value as if the intra-group transactions have not taken place. This is an example of the anti-avoidance provision that is necessary to protect a rollover policy from abuse.

**Spain**

If a subsidiary is sold by a consolidated group, gain on the disposal is subject to the PEX regime. In particular, the regime allows a tax credit up to the amount of tax liability corresponding to any net increase in retained profits of the subsidiary.

In addition, if the leaving subsidiary has been a party to an intra-group share transfer during consolidation, any deferred gain is recaptured and taxable at the group level, and is subject to the PEX regime.

**The United States**

The adjusted cost base of shares – as a result of the “investment adjustment” rules discussed above – in a leaving subsidiary is used to determined any gain or loss on the disposal of the company by the consolidated group.

In addition, if the shares have been the subject of intra-group transfer during consolidation, any deferred gain or loss on the intra-group transfer is recaptured upon either the transferor or the transferee leaving from the

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82 Section 30(5) LIS.

83 Section 73 LIS.
group. This is the same policy as for other non-share assets as discussed in Chapter 7.

8.5 Conclusion

The policies on intra-group shareholdings in the consolidation regimes of the eight countries are summarised in Table 9 below.

At joining time, all the six countries with a pooling system – namely France, Italy, Japan, New Zealand, Spain and the United States – have no tax implications for the shareholdings in a joining subsidiary. This is a logical outcome, as under a pooling system a subsidiary in general remains to a large extent as a separate entity from the parent company for income tax purposes. All of them, except Japan, adopt the same policy as for other non-share assets. Japan adopts the deemed sale policy on certain assets of a joining subsidiary, including shares held by the company.

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84 Reg. 1.1502-13(a)(5). If the transferor leaves the group, the recapture may trigger corresponding adjustments to the cost base of shares in the transferor: see Example 1 in Reg. 1.1502-13(d)(3). This issue is discussed in more detail in Chapter 9.
## Table 9 Treatment of intra-group shareholdings in the eight countries

<table>
<thead>
<tr>
<th>Country</th>
<th>Australia</th>
<th>France</th>
<th>Italy</th>
<th>Japan</th>
<th>Netherlands</th>
<th>NZ</th>
<th>Spain</th>
<th>US</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Single entity concept</strong></td>
<td>Asset-based</td>
<td>Pooling</td>
<td>Pooling</td>
<td>Pooling</td>
<td>Fiscal unity</td>
<td>Pooling</td>
<td>Pooling</td>
<td>Pooling</td>
</tr>
<tr>
<td><strong>Joining time</strong></td>
<td>Deemed share to have disappeared</td>
<td>n/a</td>
<td>n/a</td>
<td>n/a (deemed sale for shares held by joining subsidiary)</td>
<td>Deemed sale + PEX</td>
<td>n/a</td>
<td>n/a</td>
<td>n/a</td>
</tr>
<tr>
<td><strong>Intra-group transfer</strong></td>
<td>n/a</td>
<td>Neutralise</td>
<td>PEX</td>
<td>Neutralise</td>
<td>PEX</td>
<td>n/a (except shares held as revenue asset: rollover)</td>
<td>Neutralise + basis adjustments</td>
<td></td>
</tr>
<tr>
<td><strong>Leaving time</strong></td>
<td>Deferred gain or loss on intra-group transfer</td>
<td>n/a</td>
<td>Recapture (transferor /transferee) &amp; PEX</td>
<td>n/a</td>
<td>Recapture (transferor)</td>
<td>n/a (except shares held as revenue asset: deemed sale (transferee))</td>
<td>Recapture (transferor /transferee) &amp; PEX</td>
<td></td>
</tr>
<tr>
<td>Shares of leaving subsidiary</td>
<td>Taxable (based on reconstituted cost base)</td>
<td>PEX</td>
<td>PEX</td>
<td>Taxable (based on adjusted cost base)</td>
<td>PEX</td>
<td>n/a (except shares held as revenue asset: taxable)</td>
<td>PEX</td>
<td></td>
</tr>
</tbody>
</table>

Chapter 8 Treatment of Intra-group Shareholdings
Australia adopts the asset-based model, under which multiple levels of shareholdings in a consolidated group are collapsed into one level: the parent company is deemed to be holding directly all the assets of the group. In other words, shares in subsidiaries held by the parent company are deemed to have ceased to exist. This policy produces a tax-friendly environment during consolidation: intra-group share transfers are ignored completely. The cost bases of shares are pushed down – together with other items including accounting liabilities in a joining subsidiary – to the underlying assets. The push down is effected under the complex and problematic tax cost setting rules. Furthermore, serious problems arise for shares in a leaving subsidiary. As the original cost bases of shares in a subsidiary is lost forever under the asset-based model, it is necessary to reconstitute the cost bases of the shares in the leaving subsidiary under the TCS rules. The reconstituted cost base policy has proved to be equally complex and problematic.

The Netherlands does not extend the general rollover policy for non-share assets to shares in a joining subsidiary. Instead, shares are marked-to-market at the joining time. Any unrealised gain or loss in the shares is crystallised when the subsidiary joins a consolidated group. The gain or loss may be disregarded if the shares are qualified for exemption under the PEX regime. The Netherlands adopts the mark-to-market policy as an anti-avoidance measure. It is designed to prevent otherwise taxable gain on the shares from escaping taxation through consolidation. The policy may potentially decrease the attractiveness of a consolidation regime. However, the exposure is remote in the Netherlands, as the gain realised under the policy in most cases is likely to be exempt under its PEX regime.

For intra-group share transfers during consolidation, all the eight countries do not impose immediate taxation on the transfers. However, the outcome is
achieved by different means.

Four countries – namely France, Japan, Spain and the U.S. – adopt the neutralisation policy. While each group member accounts for the gain or loss on the intra-group transfers in its own tax computation, the transfer is neutralised at the group level when the parent company prepares the consolidated tax computation. This is the same policy that applies to other non-share assets in those countries. All these four countries recapture the deferred gain or loss when either the transferor or the transferee leaves the consolidated group. The recaptured gain or loss may qualify for the PEX regimes in France and Spain.

Italy and the Netherlands rely on their general PEX regimes to exempt intra-group share transfers in a consolidated group. Their PEX regimes apply to companies in general, regardless of whether they are members of a consolidated group or not. Intra-group share transfers within a consolidated group in most cases are eligible for exemption under the PEX regimes, as ownership threshold requirements under consolidation are often stricter than those under the PEX regime. The advantage of this policy option is simplicity. No additional provisions are required in the consolidation regime to deal with intra-group share transfers. The PEX regime also applies consistently throughout the consolidation cycle, covering the joining time, during consolidation, and the leaving time. A possible drawback of the policy of applying the PEX regime immediately on intra-group share transfers is that it may be less beneficial than the neutralisation policy (for example, in France and Spain). This is so if the PEX regime exempts only say 95 per cent of the gain, thus leaving the remaining 5 per cent gain taxable at the transfer time. In contrast, a neutralisation policy would defer the taxation time until the leaving time of the transferor and/or the transferee.
Australia adopts a different policy to achieve the “no taxation” outcome on intra-group share transfers. Under its asset-based model, intra-group shares in subsidiaries are deemed to have ceased to exist during consolidation. The fiction dictates that there are no tax implications for intra-group share transfers, as they are deemed not to have occurred. It follows that there is no deferred gain or loss to recapture at leaving time.

New Zealand is perhaps the luckiest country with respect to this issue. The absence of a general tax on capital gains in the country implies automatically a “no taxation” outcome for intra-group share transfers. In the rare cases that shares in a subsidiary are held as revenue assets, their intra-group transfers are subject to the rollover policy. The deferred gain or loss is recaptured when the transferee leaves the consolidated group. This is the same policy as for the intra-group transfers of other non-share assets that are subject to taxation.

The policies on the treatment of shares in a leaving subsidiary are diverse among the eight countries. This is especially so among the countries that do not have a comprehensive PEX regime for domestic corporate groups. The four European countries enjoy the benefit of an existing PEX regime. The gain or loss on disposal of shares in a leaving subsidiary is most likely eligible for exemption under the PEX regime. This policy has the advantage of simplicity, as no additional provision is required in the consolidation regime to deal with intra-group share transfers. It is also neutral, as the regime applies to both consolidated and non-consolidated groups. However, experience suggests that anti-avoidance rules are necessary to protect the PEX regime from abuse.

New Zealand again enjoys the luxury of the general policy of not taxing
capital gains. Disposal of shares in a leaving subsidiary therefore does not have any tax implication, unless they are held as revenue assets. In that case, there is no specific provision to adjust the cost bases of the shares. This is perhaps due to the fact that it is rare for shares in a consolidated subsidiary to be held as revenue assets.

Australia, Japan and the U.S., all without the benefit of a general PEX regime for domestic corporate groups, impose taxation on the disposals of shares in a leaving subsidiary. Each of the three countries — though with the same objective to deal with the dual cost bases issue — adopts a different policy to determine the cost bases of the shares in the subsidiary.

In Australia, the shares in a leaving subsidiary — that are deemed to have “disappeared” during consolidation — spring back to life. They are given back a cost base that is basically reconstituted from the cost bases — including reset cost bases created under the tax cost setting rules at joining time — of the underlying assets that the subsidiary takes away from the consolidated group. The disadvantages of this “asset-based” model are the complex and problematic TCS rules, and its failure to solve the dual cost bases issue comprehensively. In particular, double taxation is still possible under the model if a subsidiary leaves a consolidated group taking assets with hidden reserves. Due to the arbitrariness of the TCS rules, artificial gain or loss can be created and even duplicated at leaving time as the cost bases of shares in a leaving subsidiary is reconstituted based on the reset cost bases of assets in the subsidiary. The heavy reliance on market valuation of assets by the TCS rules implies high compliance costs for taxpayers and policing costs for the tax authorities, and creates avoidance opportunities. Furthermore, in terms of competitiveness, the Australian model is inferior to a general PEX regime, as the dual cost bases issue is eliminated only within a consolidated group. This
puts Australian groups in a disadvantageous position compared to the European counterparts, who can enjoy the PEX treatment even if they elect not to consolidate.

In Japan, the cost bases of shares in a leaving subsidiary are adjusted at the leaving time, reflecting in general the net change in retained profits of the company.

In the U.S., the cost bases of intra-group shares are continuously adjusted during consolidation. This option has proved to be very complex and imposes high compliance and administrative costs in practice.

In summary, the asset-based model in Australia and the investment adjustment provisions in the U.S. clearly fail to achieve the tax policy of simplicity. This reflects the inherent difficulty to deal with the dual cost bases issue. Japan’s model is a less precise but simpler solution. The PEX regime in the four EU countries is not only relatively simple, but also achieves the tax policy objective of neutrality with respect to the tax treatments between consolidated and non-consolidated groups. New Zealand achieves similar outcome as its EU counterparts due to its absence of a general capital gains tax regime.

This chapter completes the analysis of the ten key structural elements of a consolidation regime. The next chapter analyses the interaction between a consolidation regime and the rest of the income tax system. The tension between the enterprise doctrine – as adopted in a consolidation regime – and the separate entity doctrine – as adopted in general in other parts of the tax system – creates complexity. The purpose of the analysis is to assess whether a stronger application of the enterprise doctrine in a consolidation regime implies more complex interactions with the rest of the income tax system.
9.1 Introduction

This chapter analyses a number of issues arising from the interactions between a consolidation regime and other parts of the income tax system. Consolidated regimes in general treat a consolidated group as a single taxpayer pursuant to the enterprise doctrine. Individual group members lose to various extents their separate identities for income tax purposes. In contrast, other parts of the income tax systems in general are designed to operate under the separate entity doctrine, under which each corporate group member is treated as a separate taxpayer. The inherent tension between the two doctrines generates various issues from the interactions between consolidation regimes and other parts of the income tax systems.

Issues can arise from the "mismatch of taxpayers", including whether each consolidated group member should remain to be treated as a separate taxpayer for the purposes of the other income tax regimes, or the consolidated group be treated as a single taxpayer for the purposes of the other regimes.

1 The single entity concepts of the consolidation regimes in the eight countries represent a spectrum of treating consolidated subsidiaries as separate tax entities to "parts of parent company" and are discussed in detail in Chapter 4 Section 4.3.
Issues can also arise from the "truncated" application of the enterprise doctrine in the consolidation regime. Some group members, though controlled by the parent company, are excluded from consolidation. Examples of such non-consolidated group members include non-resident companies, non-resident head offices of permanent establishments ("PEs") that are consolidated group members, and resident subsidiaries held through a non-resident intermediary holding company. This raises the question of how transactions between these companies and the consolidated group should be treated.

The application of tax treaties to consolidated groups can be problematic. For instance, it may be unclear whether a consolidated subsidiary remains to be "liable to tax" and thus still qualify for treaty benefits, or whether the exclusion of non-resident companies or their PEs from consolidation violates the non-discrimination article.

Issues can also arise between consolidation regimes in two different countries, creating "double dip" possibilities. The interaction between the consolidation regimes can provide opportunities for a group to claim a single loss twice in the two countries.

Before proceeding to the discussion of the issues below, a caveat is necessary. The following discussion is not intended to be a comprehensive analysis of all issues arising from the interactions between consolidation regimes and other parts of the income tax systems in the eight countries. The analysis instead serves primarily as a general discussion to highlight some of the more common issues among the countries. Detailed analysis of the issues is beyond the scope of this thesis.

The analysis in this chapter is structured into three parts:
(1) interactions with domestic tax regimes;
(2) interactions with international tax regimes; and
(3) interactions with another consolidation regime.

9.2 Interactions with domestic tax regimes

This section analyses the following four issues arising from the interactions between a consolidation regime and other domestic tax regimes:

(1) intra-group assets between consolidated group members;
(2) loan forgiven regime;
(3) elections by consolidated group members; and
(4) leveraged buyout.

The first issue is an example of issues arising from a strong application of the enterprise doctrine. The second and third issues illustrate primarily the problems that arise from applying a tax regime designed under the separate entity doctrine to a consolidated group. The last issue represent an example of abuse of the consolidation regime by exploiting the interactions between the enterprise doctrine treatment and interest deduction rules.

9.2.1 Intra-group assets between consolidated group members

An issue relating to intra-group assets between consolidated group members is what the tax treatment should be if the asset is sold to a third party. Should it be treated as a disposal of an existing asset, or as a creation of a new asset between the consolidated group and the third party? The issue arises from the fundamental distinction between two alternative interpretations of the single entity concept under the enterprise doctrine:
(1) "existing but ignored": Under this interpretation, the intra-group asset is recognised as existing during consolidation, but does not give rise to immediate tax implications to the consolidated group as long as the asset remains within the group.

(2) "deemed not to exist": Under this alternative interpretation, the intra-group asset is deemed not to exist during consolidation, and thus does not give rise to tax implications to the consolidated group until the asset leaves the group.

These two alternative interpretations may appear to be similar, as both do not give rise to immediate tax implications as long as the asset remains with the group. However, the distinction can be crucial when the asset leaves the group.

A typical pooling system in general treats intra-group assets as "existing but ignored". Under the system, the separate entity doctrine maintains a relatively strong influence on the tax treatment of group members. Each group member remains to a large extent as a separate entity for income tax purposes. Tax computations are prepared for each group member on a stand-alone basis first, before aggregating together to arrive at the group’s consolidated taxable income or loss. Intra-group assets in general are recognised as existing within the consolidation regime, but taxation is deferred until the assets leave the group.

This interpretation of the single entity concept lies closer to the separate entity doctrine which is the underlying theory for other parts of the income tax system. Therefore, a consolidation regime with this "recognised but ignored"
policy meshes better with other regimes. In particular, the normal tax rules on disposal of assets in general apply comfortably to these assets. This is possibly the reason why the issue of intra-group assets appear to cause less concern in consolidation regimes that operate as a pooling system.

In contrast, the "deemed not to exist" interpretation poses more serious problems. Under a strong application of the enterprise doctrine, subsidiaries are deemed to be divisions of the parent company. Accordingly, the intra-group asset created during consolidation is treated as an internal arrangement within a company. In other words, the asset is deemed as "non-existing" within the consolidated group. The disposal of the asset may therefore be treated as a creation of a new asset between the consolidated group and the third party. The tax implications of creating a new asset may be very different from treating the transaction as a disposal of an existing asset.\(^2\)

The Australian consolidation regime provides some telling experience on this issue. The regime adopts the strong single entity rule ("SER") under which subsidiaries are deemed to have become divisions of the parent company. It provides a classic example of a regime that would be expected to adopt the "deemed not exist" policy. However, in practice, the tax authority struggles to apply consistently the SER to intra-group assets.

The Australian Tax Office ("ATO") in general follows the fiction of the SER and treats consolidation subsidiaries as divisions of the parent company.\(^3\) However, it has to override repeatedly the SER and adopts the "recognised but ignored" policy for intra-group assets. For instance, it recognises that intra-

\(^2\) In some countries, the difference may not be significant if for example a licence is treated as a part disposal of the corresponding intellectual property.

\(^3\) ATO, "TR 2004/11: the meaning and application of the single entity rule", paragraph 35.
group shares do exist under consolidation, thus overriding the SER that deems subsidiaries as not existing during consolidation. The ATO justifies its position with the following argument (emphasis added):^4

the single entity rule does not apply to defeat a clearly intended outcome under provisions outside the consolidation rules ... intra-group interests ... require a level of recognition in applying provisions that have regard to such interests and entities ... we think that a membership interest in an entity that is a subsidiary member of a group is able to be recognised at the time the contract [for the disposal of the interest] is made.

A couple of observations can be made on the argument:

(1) The ATO recognises the difficulty of reconciling the strong SER with the other parts of the income tax system (in this case, the capital gains tax regime). It has to make a specific override of the SER in order to ensure the capital gains tax ("CGT") rules can apply properly as intended.

(2) The ATO appears to be uncomfortable with the override. The choice of words in the tax ruling is unusual: "we think that" is seldom used in ATO official rulings and determinations. It is unclear if that is a sign of the uncertainty in the ATO’s own position on the issue.^5

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^4 ATO, "TD 2004/40: Income tax: consolidation: capital gains: does CGT event A1 in section 104-10 of the Income Tax Assessment Act 1997 happen to the head company of a consolidated group when a contract is made to sell a membership interest in a subsidiary member of the group to a purchaser outside the group?", paragraphs 3 & 4.

^5 Senior ATO officials conceded, after seven years of implementation of the SER, that the "ATO tried to get a consistent approach [to apply the SER] and has found that anomalous outcomes cannot be avoided": Des Maloney and Peter Walmsley, "ATO Perspective on Consolidation - Unravelling the Mysteries of the Single Entity Rule" (paper presented at the
override with respect to intra-group shares is a direct contradiction with the statute which explicitly stipulates that subsidiaries “are taken ... to be parts of the head company of the group, rather than separate entities, during [consolidation]”.

Another reason for the ATO’s override is to ensure symmetric treatment for both seller and buyer of the shares. By overriding the SER and treating the transaction as a disposal of existing shares in a subsidiary, the capital gains tax regime can apply symmetrically to both parties.

The ATO adopts a similar position for options and licences created between group members. Options and licences between consolidated group members are recognised as existing assets, thus allowing the normal CGT rules to apply.

However, the ATO fails to maintain a consistent “recognised but ignored” policy on all intra-group assets. In contrast to the positions discussed above, the ATO adopts the “deemed not exist” policy for an intra-group income

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4th Consolidation Symposium (organised by Taxation Institute of Australia), Sydney, 1 May 2009), at 15.
6 Section 701-1(1) ITAA1997.
7 TD 2004/40, paragraph 7.
8 ATO, “TD 2004/34: Income tax: consolidation: capital gains: does section 104-10 (CGT event A1) of the Income Tax Assessment Act 1997 apply to the head company of a consolidated group where an option granted within the consolidated group is later transferred to a non-group entity?”; and ATO, “TD 2004/35: Income tax: consolidation and capital gains tax: does section 104-10 (CGT event A1) of the Income Tax Assessment Act 1997 apply to the head company of a consolidated group where a licence granted within the consolidated group is later transferred to a non-group entity for no capital proceeds?”.
9 TD2004/34 paragraph 4 and TD2004/35 paragraph 4. A careful perusal of the determinations suggests that the ATO appears to be more confident in overriding the SER in these cases. For instance, the wordings in the determinations are more direct, without the unusual phrases such as “we think that” as in TD 2004/40.
stream (for example, future interest income stream on an intra-group loan). It tries to justify its position by the following argument (emphasis added):

Under the single entity rule, an arrangement between members of a consolidated group is taken to be an arrangement between parts of the head company. Where such an arrangement involves a right to income, the obligations and payments will not be recognised ...

The statement represents a faithful interpretation of the SER. However, it is inconsistent with the ATO positions on intra-group shares, options and licences. The position of the ATO becomes more confusing when it argues in a seemingly self-contradicting way (emphasis added):

Notwithstanding that under the single entity rule the head company did not recognise the intra-group transaction ... this [intra-group] underlying agreement may still be relevant in determining what rights and obligations the head company is taken ... to have entered into with the non-member entity.

It is unclear how the logic works in the argument. If a transaction is not recognised at all, the question is how it can be still relevant in determining tax outcome. The problematic argument highlights the difficult struggle to deal with the constant tension between the enterprise doctrine and separate entity doctrine.

10 ATO, “TD 2004/85: Income tax: can Division 16E of Part III of the Income Tax Assessment Act 1936 apply to a head company of a consolidated group where an intra-group income stream is assigned by a member of the group to a non-member?”.
11 TD 2004/85, paragraph 5.
12 TD 2004/85, paragraph 6.
The consequence of the "deemed not to exist" policy is that a transfer of the income stream to a third party is treated as *creation* of a new asset by the parent company.13 A possible reason for the ATO position on this intra-group asset is anti-avoidance concerns. By characterising the assignment as a "creation of contractual rights" similar to borrowing of money by the parent company from the third party, the ATO position ensures that the transaction is subject to the specific anti-avoidance regime (namely Division 16E of ITAA1936) dealing with *issue* of certain discounted and deferred interest securities.14

The ATO also applies the "deemed not to exist" policy on intra-group debt.15 By denying the debt as an existing asset, the transfer of debt is characterised as "effectively the borrowing of money" by the parent company.16 This position again ensures that Division 16E can apply to the "newly created" debt.17

The intra-group asset issue highlights the difficulties of applying the enterprise doctrine in a tax system that in general is premised on the separate entity doctrine. The experience suggests that the stronger the application of the

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13 TD 2004/85, paragraph 2.
14 Division 16E ITAA1936. The intention of the ATO to apply Division 16E to the assignment is clear: see TD 2004/84 paragraphs 7 & 13. It should be noted that the original intra-group loan is not subject to Division 16E as it is not recognised under the SER.
15 ATO, "TD 2004/33: Income tax: consolidation: capital gains: does a CGT event happen to the head company of a consolidated group if a debt is created within the consolidated group and later transferred to a non-group entity?".
16 TD 2004/33, paragraph 1.
17 ATO, "TD 2004/84: Income tax: can Division 16E of Part III of the Income Tax Assessment Act 1936 apply to a head company of a consolidated group where the principal of an intra-group loan is assigned by a member of the group to a non-member?".
enterprise doctrine is in a consolidation regime, the more difficulty the interactions with other parts of the income tax system tend to be.  

9.2.2 Loan forgiveness regime
The Dutch loan forgiveness rules provide an interesting example of the interaction between a consolidation regime and other parts of the tax system that are designed to operate under the separate entity doctrine. In the Netherlands, gain derived by a borrower from loan forgiveness is in general exempt from income tax to the extent of the excess over available losses. Applying the exemption rule – which is designed to apply to companies as separate tax entities – to members of consolidated groups can be problematic. This issue is illustrated in Diagram 20 below:

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Diagram 20 The loan forgiveness regime in the Netherlands

Without consolidation, the gain ($100) derived by the subsidiary from loan forgiven has to be reduced by any available losses of the company first, before the remaining amount ($20) is exempt from tax. However, if the subsidiary is in a consolidated group, the interaction between the consolidation regime and the loan forgiveness regime can have two alternative outcomes:

1) Alternative 1: the enterprise doctrine prevails:
Under this alternative, the subsidiary and the parent would be treated as one single entity. In that case, the $80 loss of the subsidiary would offset against the $120 taxable income of the parent company first before applying the exemption rule. It follows that the $100 gain from loan forgiven would be fully exempt and the group would have a net consolidated profit of $40.

(2) Alternative 2: the separate entity doctrine prevails:
Under this alternative, the exemption rule would apply first to the subsidiary on a stand-alone basis, resulting in no net taxable income or loss for the company. It means that the group as a whole would have a consolidated profit of $120.

The Dutch government believes that Alternative 1 is contrary to the objective of the loan forgiveness rules. A specific override of the single entity concept under the consolidation regime was legislated to achieve the outcome of Alternative 2. In particular, the exemption applies to a consolidated group only to the extent that the exemption would otherwise be available if the subsidiary were taxed on a stand-alone basis.\(^{20}\)

It is interesting to analyse what happens if a similar loan forgiveness regime is applied to other consolidation models. The answer depends on the extent the consolidation regimes apply the enterprise doctrine. At one extreme is a model like the Australian consolidation regime under which a strong single entity rule deems all subsidiaries as divisions of the parent company. In that case, Alternative 1 would apply, unless a specific override is stipulated.\(^{21}\)

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\(^{20}\) Article 15ac(2) Vpb.

\(^{21}\) In Australia, gain derived from loan forgiveness is not taxable, but would reduce the amount of available losses and other tax attributes of the company: Division 245 Schedule 2C ITAA1936.
At the other extreme is a typical pooling system. Each subsidiary calculates its own taxable income or loss first, before aggregating the results of all group members to arrive at the consolidated profit or loss. In that case, Alternative 2 would most likely apply, without the need for any specific override.\textsuperscript{22}

The example illustrates that the interaction of a consolidation regime with other parts of the income tax systems can produce unintended consequences. Preferential treatments such as the loan forgiveness exemption rules – that are designed under the separate entity doctrine – may produce inappropriate tax outcomes to a consolidated group. Again, the interaction between a pooling system and a loan forgiveness regime tends to be simpler.

\textbf{9.2.3 Elections by individual group members}

If group members have made inconsistent elections under the income tax law before joining a consolidated group, this raises the question of whether it is necessary for the consolidation regime to reconcile the differences, and if so, how the inconsistent elections should be reconciled.

Under a typical pooling system, group members remain to a large extent as separate tax entities. Each company prepares its own tax computation on a stand-alone basis first, before aggregating the results to arrive at the group’s consolidated taxable income or loss. Individual elections made by a group member in general would not affect the tax computations of the others. Therefore, it is not necessary for all group members to have a consistent

\textsuperscript{22} For example, this is the position in the U.S. In general, income from loan forgiveness is taxable: Reg.1.61-12. However, if the company is insolvent (defined for the purposes of the loan forgiven rules to mean that value of the company’s assets is less than its liabilities), the discharge income is excluded to the extent of its insolvency: IRC s.108(a). The excluded income instead reduces certain tax attributes of the company, including its net operating losses: IRC s.108(b). These loan forgiveness rules apply to a consolidated group as if each group member were filing a separate return: Kevin M Hennessey et al, \textit{The Consolidated Tax Return: Principles, Practice & Planning} (2003), paragraph 11.05.
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election. A pooling system in general is flexible enough to cope with inconsistent elections among group members.

The story is very different for consolidation regimes that apply a strong single entity concept. For instance, Australia's strong SER deems subsidiaries to become divisions of the parent company. The fiction poses significant problems if group members have made inconsistent elections. Allowing inconsistent elections to persist during consolidation contradicts the SER. Furthermore, elections made by a subsidiary may not be appropriate for the group as a whole.

The solution in Australia is to stipulate specific overrides of both the SER and the election provisions. On one hand, though pre-consolidation elections of a subsidiary should be deemed to be made by the parent company pursuant to the SER (through the entry history rule), a specific override allows the parent company to ignore the pre-consolidation election. On the other hand, even if the tax law stipulates that an election is "irrevocable", the consolidation regime overrides the restriction and allows the parent company to make a new election which can be different from the original election of its subsidiaries.

The elections eligible for these overrides are listed in the tax law. The government expects that "additional items will be added to this list as more elections are recognised which require this treatment".

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23 Subdivisions 715-J & 715-K ITAA1997. The rules apply equally to subsidiaries in both joining and leaving cases.

24 In general, for the purpose of determining the taxable income of the head company of a consolidated group, the entry history rule deems "everything that happened in relation to a [company] before it became a subsidiary member [of the consolidated group] to have happened in relation to the head company": s.701-5 ITAA1997.

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The following observations can be made on the Australian experience:

(1) simplicity:
The pooling system appears to be simpler as it is flexible enough to cope with inconsistent elections made by group members. In contrast, a stronger application of the enterprise doctrine tends to be more problematic and make the tax law more complex. In other words, the tax policy objective of simplicity tends to suffer with a stronger application of the enterprise doctrine.

(2) neutrality:
Elections are irrevocable for a reason, for example as an anti-avoidance measure. A strong single entity concept (like the SER) forces an override of the restriction, effective allowing consolidated groups to revoke previous elections made by group members. In contrast, the benefit of revoking an “irrevocable” election is unavailable to unconsolidated groups. This policy not only violates the original objective of making the election irrevocable, but also represents a bias towards consolidated groups, thus violating the tax policy principle of neutrality.

9.2.4 Leveraged Buyout

Problems can arise from the “truncated” application of the enterprise doctrine. For instance, if a consolidation regime treats only part of a corporate group as a single entity and excludes other group members, taxpayers may exploit the interaction between the consolidated group and the unconsolidated group members. An example of this problem is the internal leveraged buyout (“LBO”), under which interest deductions may be created. A typical structure is depicted in Diagram 21 below:

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26 EM to Tax Laws Amendment (2004 Measures No.6) Act 2005, paragraphs 1.186. The government seemingly was quite confident that the list would get longer, as that expectation was repeated twice in the Memorandum: paragraphs 1.202 & 1.224.
Most consolidation regimes do not allow S3 to join the consolidated group due to the non-resident intermediate holding company S2. To create interest deduction, P may acquire S3 from S2 with borrowed funds. As S3 joins the consolidated group, interest expenses on the borrowings in general would be deductible to the group.
For instance, in France, before a specific anti-avoidance provision was introduced, such interest expenses were deductible against taxable income of S3.\textsuperscript{27} The anti-internal LBO provisions now in general deny deduction of such interests over a period of nine years if the parent company acquires a subsidiary from a related company outside the consolidated group and the subsidiary becomes a member of the consolidated group.\textsuperscript{28}

The Netherlands has a similar anti-avoidance provision for LBO but with a different target. The provision applies if the parent company of a consolidated group acquires a company with funds borrowed from a related company.\textsuperscript{29} In other words, the provision targets leveraged buyout by a group which has sufficient own funds for the acquisition. If the provision applies, the parent company can deduct the interest expenses only against the consolidated taxable income excluding those of the acquired subsidiary for eight years.\textsuperscript{30}

The position of Australia is surprisingly lenient, given its overall emphasis on anti-avoidance in the design of its consolidation regime. Under the general deduction rules, among other things, interest expenses incurred by a parent company to acquire a company are deductible provided that the expenses are

\textsuperscript{27} This was the position since the French consolidation regime was introduced in 1988: Pierre Knoepfler and Jack Anderson, “France: Towards a Real Group Tax Harmonization” (1988) 28(6) European Taxation 171, at 175-176; and Frank Le Mentec, “French Tax Group Regimes” in The European Union and Group Relief: How will the Marks & Spencer Case Impact? (Special Report) (2006), at 4.

\textsuperscript{28} Article 223B CGI. The interest attributable to the acquisition is computed as a portion of the group’s interest expenses according to the ratio of share acquisition costs (less cash contribution) to the average debt of the group for the income year. The disallowance period was 15 years before 2007: IBFD, “Europe - Corporate Taxation - Country Analysis - France (online database)” (available at www.ibfd.org), accessed on 25 April 2009, paragraph 8.2.1.

\textsuperscript{29} Eric van der Stoel, “Analysis of Proposed Amendments to Dutch Fiscal Unity Rules” (2001) 23(1) Tax Notes International 13, at 18.

\textsuperscript{30} Johann Müller, The Netherlands in International Tax Planning (2005, IBFD, Amsterdam), at 259-260. After the eight-year period, any unused interest expenses are deductible without limitation: Stoel, ibid, at 18.
incurred in the production of assessable income of the parent company.\textsuperscript{31} There is no specific provision to deal with internal LBO by a consolidated group. It appears that the general deduction rule would apply. As the acquisition of a new consolidated member is expected to generate assessable income to the parent company, the interest expenses incurred for the acquisition would likely be deductible under the general deduction rules.\textsuperscript{32}

The above position may also be inferred by the ATO lenient positions on another form of intra-group acquisition, namely the acquisition of existing consolidated group members by the parent company. A typical example of such acquisition is depicted in Diagram 22 below:\textsuperscript{33}

\begin{footnotesize}
\textsuperscript{31} Section 8-1 ITAA1997. For instance, it is sufficient to demonstrate that the interest expenses are incurred with the intention to generate dividend income in future years: \textit{Federal Commissioner of Taxation v Total Holdings (Australia) Pty Ltd} [1979] FCA 30.

\textsuperscript{32} Of course, deductibility of the interest expenses is subject to other provisions such as the thin capitalisation rules. Also, expenses of capital nature are in general not deductible. Detailed discussion of the rules is beyond the scope of the thesis. Furthermore, there is always an exposure to the general anti-avoidance provision (Part IVA of ITAA1936), which in broad terms would apply if a taxpayer enters into a transaction with a dominant purpose of tax avoidance.

\textsuperscript{33} This example is based on the example in ATO, "TD 2006/48: Income tax: consolidation: can the head company of a consolidated group claim a deduction under section 8-1 of the Income Tax Assessment Act 1997 for interest paid on funds borrowed from outside the group, where the funds were borrowed either before or after formation of the consolidated group, by it or a subsidiary member to buy shares in an existing subsidiary member from another member of the consolidated group?".
\end{footnotesize}
In this example, P acquires S3 – an existing consolidated group member – from its other consolidated subsidiaries with borrowed funds. The ATO position is that the interest expenses are deductible if S1 and S2 use the sales proceeds to acquire income-generating assets.\textsuperscript{34} Under the SER, the income-

\textsuperscript{34} TD 2006/48 paragraph 2. The ATO position on internal LBO within a MEC group is even more lenient. The interest expenses would still be deductible even if an acquisition of an existing consolidated member by the head company does not result in additional income-
generating assets are deemed to be acquired by the parent company, thus satisfying the general deduction rules.

Some observations can be made on the ATO position:

(1) Implication for acquisition of new subsidiary member:
Based on the rationale of the ATO, it appears that interest expenses incurred on LBO for a new subsidiary member would also be deductible, provided that the expenses are incurred to generate assessable income for the parent company.

(2) Avoidance opportunities:
Compared with the other countries, Australia seems relaxed towards the avoidance opportunities created by internal LBO. After all, S3 is not only a related company to the parent company, but is already within the consolidated group. Acquiring S3 by borrowing appears to be a blatant arrangement to create interest deduction. It is unclear why the policy in Australia is so lenient on this issue.35

35 A possible reason for the relatively relaxed position in Australia may be the absence of a general participation exemption regime. The seller of the shares in the subsidiary may be subject to tax on any gain derived from the share disposal. Furthermore, blatant arrangements with a dominant purpose for tax benefits may be subject to the general anti-avoidance provision in Australia.
9.3 Interactions with international tax regimes
This section analyses the following issues arising from the interactions between consolidation regimes and international tax regimes:

(1) consolidated subsidiary: eligible for tax treaty benefits?
(2) Non-discrimination: PEs;
(3) Non-discrimination: non-resident companies;
(4) Dual status of PEs as consolidated group members;
(5) foreign tax relief regime;
(6) thin capitalisation regime; and
(7) controlled foreign company regime.

The first three issues are examples of issues arising from the application of tax treaties to consolidated groups. The fourth issue illustrates the problems of including PEs as consolidated members, especially the dual status of a PE being a part of a consolidated group under the enterprise doctrine and also being a part of its head office as a legal and economic fact. The fifth and sixth issues are examples of problems arising from applying international tax regimes designed under the separate entity doctrine to a consolidated group. The last issue illustrates that a regime designed primarily under the enterprise doctrine (that is under a "group" concept) tends to operate comfortably with consolidated regimes.

9.3.1 Consolidated subsidiary: eligible for tax treaty benefits?
A corporate group in general is subject to income tax on its consolidated taxable income. If the consolidated tax liability is imposed on the parent company, a subsidiary member may not be liable to income tax anymore. In that case, there is an exposure that the subsidiary would not be eligible for tax treaty benefits.
Under the OECD Model Convention, a company is eligible for treaty benefits only if it is a “resident” of one or both of the contracting states.36 “Resident” is defined to mean “any person who, under the laws of that State, is liable to tax therein by reasons of his ... residence, place of management or any other criterion of a similar nature ...” (emphasis added).37 It follows that if a consolidated subsidiary member is no longer liable to tax, it may not be regarded as a resident of a country for treaty purposes. In practice, whether a consolidated subsidiary remains as a resident under tax treaty depends on the exact definition of residents in the particular treaty, and how closely the treaty follows the OECD Model Convention. The following paragraphs discuss the experience in some of the eight countries.

In Australia, the strong SER deems subsidiaries to become divisions of the parent company during consolidation. A strict interpretation of the SER would suggest that consolidated subsidiaries are no longer subject to tax; instead only the parent company is. However, in most cases the practical exposure of losing the treaty benefits may be remote as most of the Australian tax treaties do not adopt the “liable to tax” provision of the OECD Model Convention. For instance, the Australia-UK treaty in general defines “resident of Australia” to mean a person who “is a resident of Australia for the purposes of Australian tax”.38 The definition avoids effectively the “liable to tax” issue.

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36 Article 1, OECD, Model Convention with Respect to Taxes on Income and on Capital (2010) ("OECD Model Convention").
37 Article 4, OECD Model Convention.
38 Article 4, Australia-UK Tax Treaty. There is a special provision dealing with the residence of dual listed companies: Article 5.
A company must be a resident of Australia before it can join a consolidated group.\textsuperscript{39} However, the strong SER under which the subsidiary is deemed to have become a part of the parent company leads to the question of whether it means that the company is deemed to have “disappeared” and thus incapable of having a residence.\textsuperscript{40}

The tax law does not provide a direct answer to this question. However, the Australian income tax law limits the scope of the SER in such a way that it only applies for the purposes of determining the Australian income tax liabilities of the consolidated group members. In particular, the tax law stipulates that the SER applies to deem subsidiaries as parts of the parent company “for the purposes [of] working out the amount of the … liabilities for income tax” of the parent company and the subsidiary members.\textsuperscript{41} Arguably, it implies that the SER does not apply for the purposes of tax treaties. It should be so especially from the perspective of the other contracting state, which applies its own income tax law instead of the Australian income tax law.

This position is supported by the ATO’s interpretation of the SER with respect to its application to third parties outside a consolidated group. The ATO states that (emphasis added):\textsuperscript{42}

\begin{quote}
The SER ensures that the members of a consolidated group are treated as a single entity for the purpose of applying income tax laws to that group.
\end{quote}

\textsuperscript{39} Section 703-15(2) ITAA1997.

\textsuperscript{40} The Dutch fiscal unity regime before 2003 had a similar concern: see discussion above and also Rudolf J. de Vries, “Branch Report: Netherlands”, in International Fiscal Association, Cahiers de Droit Fiscal International Volume 89b: Group Taxation (2004), at 467.

\textsuperscript{41} Section 701-1 ITAA1997.

\textsuperscript{42} ATO, “TR 2004/11: the meaning and application of the single entity rule”, paragraph 12.
The SER does not affect the application of those laws to an entity outside of the consolidated group. *The income tax position of entities outside of the group will not be affected by the SER* when they deal or transact with a member of a consolidated group.

In other words, the ATO’s position is that an entity outside a consolidated group should ignore the SER in determining its income tax liability. The logic implies that a contracting state may similarly ignore the SER for the purposes of the tax treaty. Of course, the ATO’s interpretation of the SER is not binding on other treaty countries. Nevertheless, it provides a basis to argue that a subsidiary member remains to be in existence and thus a resident of Australia for treaty purposes.

Most of the Australian treaties adopt a definition of “resident” similar to that in the Australia-UK treaty. However, there are exceptions. For instance, the definition of “resident” in the Australia-China treaty follows closely the OECD Model Convention, relying on the concept of “liable to tax”. In particular, the treaty defines “resident” as “a person who is *fully liable to tax* therein by reason of being a resident of that State under the tax law of that State” (emphasis added).

As explained above, under the strong SER, only the parent company of a consolidated group is liable to income tax. As consolidated subsidiaries are deemed to have become divisions of the parent company, it does not look promising that consolidated subsidiary members remain “liable to tax”. The tax law stipulates that if the parent company defaults in meeting its obligation

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43 Examples include treaties with all the other seven countries in the comparative analysis in this thesis.

44 Article 4(1), Australia-China Tax Treaty.
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to pay the group’s consolidated tax, all group members have “joint and several liability” to the group’s consolidated tax liability. In other words, a subsidiary member is “liable to tax” only if the parent company defaults. The provision therefore may not help to resolve the issue if the parent company promptly meets its tax payment obligations.

The Netherlands was so concerned about this “liable to tax” exposure that its consolidation regime was amended in 2003. Before the amendment, the Dutch fiscal unity regime operated based on the concept of “absorption”, under which consolidated subsidiaries were deemed to have ceased to exist as separate entities for income tax purposes. It was controversial whether a consolidated subsidiary could still be regarded as “liable to tax” in the Netherlands.

The fiscal unity legislation was amended in 2003 to remove the uncertainty. The absorption concept was replaced with a deemed attribution of activities, assets and liabilities of subsidiaries to the parent company. The law now stipulates explicitly that the subsidiary – together with all other group members – remains to be liable to tax, even though the consolidated tax liability is levied on the parent company. The government believes that the

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45 Division 721 ITAA1997.

46 This issue is also relevant in the context of foreign tax credit. It is not clear whether foreign jurisdictions will treat the tax paid by a consolidated group as tax paid by the parent company or, at least in part, paid by individual group members: Paul O’Donnell and Ken Spencer, “Branch Report: Australia” in International Fiscal Association, Cahiers de Droit Fiscal International Volume 89b: Group Taxation (2004), at 142.

47 Vries, above note 40, at 467.


49 Article 15(1) Vpb.
amended provision ensures that consolidated subsidiaries remain to be eligible to tax treaty benefits.

It appears that Japan has similar problems. The application of tax treaty to consolidated subsidiaries is uncertain as it “depends on articles of the tax treaty concerned whether or not the subsidiaries are regarded as separate ‘residents’ for treaty purposes …”.

In New Zealand, the tax law is clear that each consolidated group member is jointly and severally liable to the consolidated tax liability. It follows that all group members are “liable to tax” in New Zealand. The position is less clear if the consolidated group elects to limit the joint and several liability to particular group member(s). In that case, some group members may cease to be “liable to tax”.

In summary, there is an exposure that a consolidated subsidiary may cease to be “liable to tax” and thus become ineligible to tax treaty benefits. The extent of the exposure depends on the definition of “resident” in the tax treaty in question. The experience in the Netherlands and New Zealand suggest that a possible solution may lie in the way the tax liability of a consolidated group is defined in the consolidation regime. The exposure of losing treaty benefit can be minimised by stipulating that, despite the parent company being the primary taxpayer responsible for payment of consolidated tax liability, every consolidated member remains “liable to tax”.


51 Section FM 3(5) ITA2007.

52 A consolidated group is allowed to do so under section FM 4 ITA2007.
9.3.2 Non-discrimination: PEs

In Chapter 5 “Definition of a Group”, the comparative analysis of the consolidation regimes in the eight countries reveals that PEs of non-resident companies are always excluded from becoming a member of a consolidated group in the four non-EU countries, but not so in the four EU countries. This situation is summarised in Table 10 below:

**Table 10 PEs as consolidated group members in the eight countries**

<table>
<thead>
<tr>
<th>PE as consolidated member</th>
<th>EU</th>
<th></th>
<th></th>
<th></th>
<th>Aus</th>
<th>Japan</th>
<th>NZ</th>
<th>US</th>
</tr>
</thead>
<tbody>
<tr>
<td>Parent</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✗</td>
<td>✗</td>
<td>✗</td>
<td>✗</td>
</tr>
<tr>
<td>Subsidiary</td>
<td>✓</td>
<td>✗</td>
<td>✓</td>
<td>✗</td>
<td>✗</td>
<td>✗</td>
<td>✗</td>
<td>✗</td>
</tr>
</tbody>
</table>

One of the issues arising from excluding PEs from consolidation is whether the exclusion violates the non-discrimination article in tax treaties.

Article 24(3) of the OECD Model Convention stipulates that (emphasis added):

The taxation of a permanent establishment ... in the other Contracting State shall not be less favourably levied in that other State than the taxation levied on enterprises of that other State carrying on the same activities.
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The exclusion of a PE from consolidation denies the possibility of offsetting its taxable income or loss with group companies in the country. It appears that there may be an exposure that the exclusion is contrary to the non-discrimination article.

Countries in the EU are under additional pressure on this issue. Articles 20 and 48 of the Treaty on the Functioning of the European Union ("EC Treaty") – which has replaced the Treaty establishing the European Community since 2010 – stipulates the "freedom of establishment" principle, which in general prohibits a Member State from imposing restrictions on the freedom of companies to have establishments – including branches and subsidiaries – in other Member States. The principle has proved to be powerful in challenging and reshaping various domestic tax rules. Table 10 above suggest that consolidation regimes in the European countries are not immune from the pressure.

A detailed discussion of the non-discrimination article and the EC Treaty is beyond the scope of this thesis. However, the following paragraphs provide a brief summary of the positions in the eight countries.

France and the Netherlands have the most flexible policy on PEs. They allow PEs to be consolidated, either as the head entity or a subsidiary member. For instance, the Dutch policy was a specific response to the non-discrimination issue. In particular, the Dutch Supreme Court held in 2004 that an exclusion of PE from the fiscal unity regime was contrary to the non-discrimination provision in the Dutch-UK treaty.\textsuperscript{54}

\textsuperscript{53} For example, the UK group loss relief regime was challenged and subsequently amended as a result of the ECJ decision in the \\textit{Marks & Spencer} case (C-446/03).

In Italy and Spain, PEs are allowed to be the head entity of a consolidated group, but not as a subsidiary member. The experience in Spain is interesting. The Supreme Court in Spain held in 2003 that the exclusion of a PE from its consolidation regime was not contrary to the non-discrimination provision in the Spain-Belgium treaty. However, the favourable judgment failed to provide sufficient comfort to the government. The law was amended immediately after the judgment to allow a PE to be the head entity of a consolidated group. The prompt and direct override of the court decision reflected the government’s belief that the PE exclusion was in contrary to both the non-discrimination article in the treaty and also the EC Treaty. Nevertheless, the restriction on PEs from being a subsidiary member remains a potential breach of the non-discrimination article.

All the four non-EU countries – namely, Australia, Japan, New Zealand and the U.S. – exclude PEs from consolidation. However, each country justifies the position with different arguments. Australia perhaps has the easiest case to answer. The non-discrimination article was not included in virtually all of its treaties until the 2003 treaty with the U.K. Even in the 2003 Australia-U.K.

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56 Ibid, at 479.

57 This is also a concern in Italy: Francesco Leone and Emiliano Zanotti, “Italian Domestic Tax Consolidation: New Opportunities for Tax Planning” (2005) 45(5) *European Taxation* 187, at 198.

58 The 1983 treaty with the U.S. had a watered down provision that was not enacted into the Australian law: Graeme S Cooper et al, *Income Taxation: Commentary and Materials* (Fifth ed, 2005, Thomson, Sydney), at 854. For the effect of the inclusion of this article in the UK treaty, including the trigger of renegotiation of Australian tax treaties under the most-favoured nation protocols, see: ibid, at 855. For example, a new treaty between Australia and New Zealand was signed in June 2009, including the non-discrimination article with a similar exception for consolidation regime as in the Australia-U.K. treaty.
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treaty, the non-discrimination article is subject to a number of qualifications, including one specifically for consolidation.  

This Article shall not apply to any provision of the laws of a Contracting States which ... (c) provides for consolidation of group entities for treatment as a single entity for tax purposes ...  

The specific exclusion of the consolidation regime from the non-discrimination article suggests that Australia is concerned that the regime – particularly the exclusion of non-resident companies and their PEs from consolidation – may be contrary to the article.  

It appears that Japan does not consider the exclusion of PE from its consolidation regime a breach of the non-discrimination article. One argument is based on the premise that though the consolidation regime provides "favourable" tax treatment to domestic corporations, it does not impose "less favourable" taxation on the PEs of non-resident corporations than those of resident corporations.

59 Article 25(6)(c) Australia-UK Treaty.

60 The article also provides that Australian resident companies owned by UK residents can access the consolidation regime "on the same terms and conditions as other Australian resident companies".

61 Specific reference to consolidation regimes in a tax treaty is uncommon. Another example of such specific provision appears in the Protocol to the France-Spain Tax Treaty. Article 17(a) of the Protocol stipulates that: "Where the legislation of a Contracting State allows companies resident in that State to determine their taxable profits by means of consolidation including, in particular, the results of subsidiaries resident in the other Contracting State or of permanent establishments situated in that other State, the provisions of the Convention shall not prevent the application of that legislation". It is possible that the provision is more relevant to the French worldwide consolidation regime, which includes non-resident subsidiaries of a French parent company in the consolidated group. Detailed discussion of the regime is beyond the scope of this thesis.

62 Komamiya, above note 50, at 401.
New Zealand does not believe that the exclusion of PEs from its consolidation regime is contrary to the non-discrimination article. Even though the non-discrimination article of the new Australia-New Zealand treaty contains a specific qualification for consolidation regimes, the qualification is most likely inserted at the request of Australia.

The U.S. also does not believe the exclusion of PEs from its consolidation regime is contrary to the non-discrimination article. Pursuant to the Technical Explanation to the Model US Treaty, the article applies "only if the ... residents of the two States are comparably situated ... if the difference in treatment is directly related to a tax-relevant difference in the situations of the domestic and foreign persons being compared, that difference is not to be treated as discriminatory" (emphasis added). It has been argued that since a non-resident company is not subject to U.S. tax on its worldwide income even if it has a PE in the U.S., it is not "comparably situated" as a U.S. resident company. Therefore, the exclusion of its PE from consolidation does not violate the non-discrimination article.


64 Article 24(5)(c) Australia-New Zealand Treaty. The treaty was signed in June 2009. The qualification for consolidation regimes was virtually the same as the one in the Australia-UK Treaty.

65 For instance, the qualification is absent in most of the treaties of New Zealand, including those with the UK and the U.S.


67 Giovanna Terese Sparagna, “Branch Report: United States” in International Fiscal Association, Cahiers de Droit Fiscal International Volume 89b: Group Taxation (2004), at 726. This is consistent with the current OECD position: Commentary on Article 24(3) paragraph 41.
9.3.3 Non-discrimination: non-resident companies

The exclusion of non-resident companies from consolidation seems to be less controversial than the exclusion of PEs. Two provisions of the non-discrimination article of the OECD Model Convention are relevant to this issue: Articles 24(1) and 24(5).

Article 24(1) stipulates that (emphasis added):

Nationals of a Contracting State shall not be subjected in the other Contracting State to any taxation ... which is other or more burdensome than the taxation ... to which nationals of that other State in the same circumstance, in particular with respect to residence, are or may be subjected.

The term “national” is defined in the Model Convention to include companies incorporated or registered in a country.68

It is clear from the wording of the provision that it is designed to prevent discrimination due to “nationality” instead of “residence”.69 In other words, a non-resident company is not in the same circumstance as a resident company for the purposes of the Article. It follows that the exclusion of non-resident companies from consolidation regimes does not breach Article 24(1). The Commentary on Article 24 also suggests that a consolidation regime that is exclusive to companies incorporated in the country (that is, exclusion based on

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68 Article 3(1)(g) OECD Model Convention; and Commentary on Article 24, paragraph 17.
69 OECD Commentary on Article 24, paragraphs 7 & 17.
incorporation, instead of residence) may not trigger the Article, if the foreign-incorporated company is regarded as a non-resident.\textsuperscript{70}

The second provision that is relevant to the exclusion of non-resident companies is Article 24(5), which stipulates that:

Enterprises of a Contracting State ... wholly or partly owned or controlled ... by one or more residents of the other Contracting State, shall not be subjected in the first-mentioned State to any taxation ... which is other or more burdensome than the taxation ... to which other similar enterprises of the first-mentioned States are or may be subjected.

The provision is designed to prevent discrimination of foreign-owned resident companies as compared to domestic-owned ones.\textsuperscript{71} It is clear that the provision is not intended to “force ... consolidation between a resident company and a non-resident parent company”.\textsuperscript{72} Provided a consolidation regime does not impose more burdensome treatment to foreign-owned resident companies as compared to local-owned ones, it should not be contrary to the provision.\textsuperscript{73}

\textsuperscript{70} This is because the foreign-incorporated company, being a non-resident, would not be “in the same circumstance” as other consolidated group members who are residents: see Example 5 in OECD Commentary on Article 24, paragraphs 24 & 25.

\textsuperscript{71} OECD Commentary on Article 24, paragraph 77.

\textsuperscript{72} Ibid.

\textsuperscript{73} This is the current OECD position: Commentary on Article 24(3) paragraph 41. This is also the position in the U.S. In particular, the U.S. believes that Article 24(5) of its Model Convention (which is virtually the same as the OECD counterpart) “does not require a Contracting State to allow foreign corporations to join in filing a consolidated return with a domestic corporation or to allow similar benefits between domestic and foreign enterprises”: Technical Explanation to Article 24 of the U.S. Model Income Tax Convention (2006).
In summary, provided the non-discrimination article in a tax treaty follows closely the OECD Model Convention, it is unlikely to be triggered by the exclusion of non-resident companies from consolidation.

As discussed above in the context of exclusion of PEs from consolidation, the EU countries are subject to additional pressure on the issue. The “freedom of establishment” principle of the EC Treaty has put pressure on the consolidation regimes of Member States that exclude non-residents of other Member States. For instance, some commentators believe that “it is beyond reasonable doubt” that the Dutch fiscal unity regime imposes a restriction on the freedom of establishment by excluding non-resident EU companies.\(^{74}\)

### 9.3.4 Dual status of PEs as consolidated group members

The inclusion of PEs of non-resident companies in a consolidated group creates some interesting issues. This is so especially under a consolidation regime that in general treats consolidated subsidiaries as divisions of the parent company. For example, in the Netherlands, if a PE acts as the head entity in a fiscal unity, the general effect is that assets and activities of the subsidiaries are deemed as those of the PE.\(^{75}\) This represents a strong application of the enterprise doctrine. However, from both legal and economic perspectives, the PE is part of the non-resident head office.

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\(^{74}\) Sjoerd Douma and Caroline Naumburg, “Marks & Spencer: Are National Tax Systems Éclairé?” (2006) 46(9) European Taxation 431, at 439. Detailed discussion of this issue is beyond the scope of this thesis. However, to the surprise of some commentators, in early 2010, the ECJ decided in *X Holding* (Case C-337/08) that though the Dutch tax rule of excluding non-resident subsidiary from consolidation was contrary to the freedom of establishment principle in the articles of the Treaty on the Functioning of the European Union, this policy was justified by the need to ensure a balanced allocation of tax jurisdiction. For a critical analysis of the judgement, see for example Servaas van Thiel and Marius Vascega, “*X Holding: Why Ulysses should Stop Listening to the Siren*” (2010) 50(8) European Taxation 334.

\(^{75}\) For more detail of the single entity concept, see Chapter 4 Section 4.3.
The conflict between the fiction of the fiscal unity regime – namely, treating the PE as a separate tax entity from its head office – and the legal and economic fact – namely, the PE as a part of its head office – is a more general and significant issue for tax treaty purposes. Detailed discussion of this issue is beyond the scope of this thesis. The following paragraphs serve to illustrate some of the issues arising in the context of consolidation regimes.

In the Netherlands, PEs are allowed to be consolidated group members under its fiscal unity regime. This raises the question of whether transactions between the non-resident head office and a subsidiary in the consolidated group should be ignored. Consider the structure in Diagram 23 below:
On the one hand, if the PE remains to be treated as a part of the head entity, transactions between a consolidated subsidiary and the non-resident head office should be treated as internal transactions within the non-resident company, and thus should be ignored.
On the other hand, it is also possible to argue that the consolidation fiction should prevail in the sense that the consolidated group – which is formed between the PE and the subsidiary – is treated as a separate entity from the non-resident head office. In that case, transactions between the group and the head office should be recognised as those between related parties.

For example, if the subsidiary pays $100 million interest expenses to the non-resident head office, the issue is whether the amount should be deductible to the consolidated group. The fiscal unity regime resolves the issue by a specific provision to recognise transactions between the subsidiary and the non-resident head office. For instance, the interest expenses are regarded as interest payments between related parties and be subject to normal restrictions on interest deduction (for example, thin capitalisation rules). This example illustrates the challenges arising from a strong application of the enterprise doctrine in practice.

Similar to the inclusion of a PE as the head entity, the consolidation fiction prevails in the Netherlands with respect to transactions between the non-resident head office of a PE that is included as a consolidated subsidiary member and other consolidated group companies. A typical structure is depicted in Diagram 24 below:

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76 The Netherlands in general attributes profits to a PE based on the assumption that the PE is a “separate, distinct and independent” enterprise from the head office: Marcel Romyn, “Branch Report: Netherlands” in International Fiscal Association, Cahiers de Droit Fiscal International Volume 91B: The attribution of profits to permanent establishments (2006), at 483-484.

77 Vries, above note 40, at 478-490.
Transactions between the parent company and the non-resident head office in general are recognised for income tax purposes. For example, participation exemption regime applies as if there is no fiscal unity.\(^78\)

**9.3.5 Foreign tax relief regime**

Foreign tax relief regimes – for example, foreign tax credit ("FTC") and foreign income exemption – in general are designed under the separate entity

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\(^{78}\) Vries, ibid, at 480.
doctrine to operate on a company stand-alone basis. This raises the question of how the regimes should operate on consolidated groups.

Many countries apply the enterprise doctrine and treat a consolidated group as one single taxpayer for the purposes of their foreign tax relief regimes. For instance, in Australia, the strong SER dictates that a consolidated group maintains only one foreign tax credit account.\(^79\) Foreign tax credits generated by group members during consolidation are deemed to have been generated by the parent company. Any pre-consolidation credit that a subsidiary brings into the group remains with the parent company even if the subsidiary subsequently leaves the group.\(^80\) In the U.S., FTC must be computed on a consolidated basis by aggregating the separate computations of all group members.\(^81\) Similar rules apply in New Zealand, under which a consolidated group in general is treated as a single company.\(^82\) The fiscal unity regime in the Netherlands adopts a similar policy. In general, foreign profits of a company are exempt from tax.\(^83\) The exemption regime applies to a consolidated group as if it is a single taxpayer.\(^84\) However, this policy may

\(^79\) Subdivision 717-A ITAA1997. Since 1 July 2008, the old foreign tax credit rules have been replaced by the foreign income tax offset regime: Division 770 ITAA1997. Among other things, excess foreign tax credits are no longer allowed to be carried over.

\(^80\) This is achieved with a specific override of the “exit history rule”: section 717-30 ITAA1997. This reflects a consistent policy of the Australian consolidation regime, under which a leaving subsidiary is treated as a different company from the one before joining the consolidated group. For more discussion of this policy, see analysis of the SER in Chapter 4 Section 4.3.

\(^81\) Reg. 1.1502-4; and Hennessey, above note 22, paragraph 16.06.

\(^82\) Section FM 6 ITA2007.


\(^84\) Müller, above note 30, at 255.
produce adverse results in certain situations. For example, consider the scenario depicted in Diagram 25 below:85

**Diagram 25 Interaction between the foreign income exemption and consolidation regimes in the Netherlands**

Without consolidation, P would get an exemption for the foreign profit of $30 of PE1 under the exemption with progression rules, while the foreign loss of $20 of PE2 would be carried forward to future years to offset against foreign

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85 This example is based on the example in: ibid.
profits generated by PE2. However, if P and S form a fiscal unity, the group is treated as one single taxpayer for the purposes of the foreign income exemption regime. The foreign profit of $30 has to be offset against the foreign loss of $20 first before applying the exemption. The group as a whole would get an exemption for only $10, instead of the $30 if the group does not consolidate.86

Positions in some countries are less clear. For instance, in Japan, the foreign tax credit regime seems to operate in a mixed approach for consolidated groups.87 The amount of FTC limit is first calculated on a consolidated group basis. The consolidated group limit is then allocated to each group member and applied individually against their foreign tax paid. The resulting available FTC of each group member is then offset against the consolidated tax liability at the group level.

9.3.6 Thin capitalisation regime
A tax regime may be designed to apply different rules to a company depending on its particular circumstances. Applying such a regime to a consolidated group can be problematic. For example, the thin capitalisation regime in Australia applies different limitations on interest deductions to different categories of companies, for example outward vs inward investors, general vs financial investors, and authorised deposit taking institutions (“ADI”) (that is, banks) or non-ADI.88 Detailed discussion of the

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86 This may be merely a timing issue, if the two PEs generate a net profit of more than $20 in say next year. This is because the $20 foreign loss of PE2 will be effectively recaptured in next year’s calculation of the amount of exemption under progression. Detailed discussion of the exemption calculation is beyond the scope of this thesis. For more information and sample calculations of the exemption rules, see IBFD, “Corporate Taxation – Country Analysis – the Netherlands (online database)” (available at www.ibfd.org), accessed on 4 September, 2011, paragraph 7.2.6.

87 Article 81-15 CTA.

88 Division 820 ITAA1997.
categorisation rules is beyond the scope of this thesis. For the present purpose, it is sufficient to understand that the rules are designed to operate on a company stand-alone basis. Each company is to be categorised before the corresponding tests and interest deduction rules apply.

The thin capitalisation regime struggles to apply to a consolidated group which consists of companies falling into different categories. Under the strong SER, all subsidiaries are deemed to have become divisions of the parent company. This begs the question of how the thin capitalisation rules can be applied to the parent company that in fact consists of subsidiaries of different categories.

The solution is to stipulate a specific categorisation rule for consolidated groups.\(^89\) In broad terms, the rules apply to a consolidated group depending on one single group-wide categorisation. For example, if among other things, the group has at least one financial entity, the whole consolidated group is categorised as an “Outward investor (financial)”.\(^90\) This is so even if some other group members fall into other categories on a stand-alone basis. In other words, the categorisations of individual group members may be overridden by the special rules.

One may question whether the specific override of the categorisation of each group member would defeat the original objective of the thin capitalisation rules. After all, the sophisticated categorisations in the thin capitalisation regime presumably are carefully designed to ensure the application of the most

\(^89\) Subdivision 820-FA ITAA1997. Another set of special rules applies if the parent company of a consolidated group is a member of a wholly-owned group with a foreign financial institution: Subdivision 820-FB ITAA1997.

\(^90\) Section 820-583(3) ITAA1997. Similar rule applies if at least one group member is an ADI: section 820-583(7) ITAA1997.
appropriate interest deduction limitations to each category of companies. The overrides of these categorisations within a consolidated group may imply applying inappropriate limitations to the group members.

The problematic application of the thin capitalisation rules in Australia contrasts with the relatively comfortable application in Italy. Under the Italian thin capitalisation regime, interest expenses of a company are fully deductible against interest income earned in the same income year. Any excess interest expenses are deductible up to 30 per cent of the “gross operating income” derived from its core business. “Gross operating income” is defined basically to mean earnings before interest, taxes, depreciation and amortisation (“EBITDA”). Any excess interest expenses over the “30% EBITDA” threshold can be carried forward to future years.

Under the pooling system of the Italian consolidation regime, the “30% EBITDA” regime is applied to each individual group member on a stand-alone basis in the normal way. Any excess interest expenses over the “30% EBITDA” threshold can be used to offset against taxable income of another group member up to the latter’s threshold. In other words, the consolidated group is treated as a single company for the purpose of the “30% EBITDA” limitation.

A couple of reasons explain the relatively simple application of the rules to consolidated groups in Italy. First, the design of the Italian regime is simpler

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91 Article 96 CGI. For more information about this regime which was introduced in 2008, see IBFD, “Europe - Corporate Taxation - Country Analysis - Italy (online database)” (available at www.ibfd.org), accessed on 25 April 2009, paragraph 2.7.5.

92 IBFD, “Europe - Corporate Taxation - Country Analysis - Italy (online database)” (available at www.ibfd.org), accessed on 25 April 2009, paragraphs 2.7.5 and 9.2.1. Pre-consolidation excess interest expenses over the 30% EBITDA threshold are quarantined and can not be used by other group members.
than the Australian one. One single limitation applies consistently to all companies, instead of multiple alternative limitations which can create inconsistent treatments among group members. Second, and more importantly, the pooling system in Italy meshes more easily with the thin capitalisation regime as both embrace the separate entity doctrine to a large extent. Even if Italy had a regime similar to the Australian one with multiple alternative limitations, one can imagine that the regime should still mesh easily with the consolidation regime. In particular, the regime is applied to each individual group member on a stand-alone basis. Each company can apply the appropriate limitation according to the regime, independent of the treatments of other group members.

An interesting comparison is provided by the U.S. “earning stripping” regime,\(^93\) which is similar to Italy’s “30% EBITDA” regime. It also has a single limitation for all companies. The U.S. regime applies to limit deduction of interest expenses paid to related tax-exempt parties if, among other things, the debt to equity ratio of a company is more than 1.5.\(^94\) In that case, the deduction of interest expenses in excess of interest income is limited to 50 per cent of the “adjusted taxable income” plus any excess interest limitation for the prior three years. Any disallowed interest can be carried forward to future years.

In comparison with its Italian counterpart, the U.S. thin capitalisation regime applies to consolidated groups with a stronger influence of the enterprise doctrine. For the purpose of the regime, all members of a consolidated group are treated as one taxpayer.\(^95\) Adjusted taxable income, interest income and

\(^93\) IRC s.163(j).

\(^94\) This is known as the safe harbour rule: IRC s.163(j)(2)(A)(ii).

\(^95\) IRC s.163(j)(6)(c) and Proposed Reg. 1.163(j)-5(b)(2).
interest expenses are computed on consolidated basis. The debt/equity ratio is also determined on a group basis. This approach produces similar results as the Italian counterpart with respect to interest expenses incurred by the group during consolidation. However, the treatment of pre-consolidation disallowed interest and excess limitations of a joining subsidiary can be complex.\(^ {96}\)

New Zealand provides an example of a consistent application of the enterprise doctrine in both the consolidation and thin capitalisation regimes. In broad terms, the New Zealand thin capitalisation regime denies deduction of excessive interest expenses of non-resident controlled companies whose debt/asset ratio exceeds (i) 75 per cent (the safe-harbour threshold); and (ii) 110 per cent of its worldwide ratio.\(^ {97}\)

Both the 75 per cent and 110 per cent thresholds are defined on a “group” basis. For instance, the 75 per cent threshold is defined as the debt/asset ratio of the “New Zealand group” to which the company belongs.\(^ {98}\) It is computed under the accounting consolidation rules.\(^ {99}\) The definition of “New Zealand group” adopts an ownership threshold of either 50 per cent or 66 per cent.\(^ {100}\) Furthermore, the definition adopts similar factors of control as those in the consolidation regime. It implies that these thresholds in the thin capitalisation regime cover well the 100 per cent threshold of the consolidation regime. In

\(^{96}\) Proposed Reg. 1.163(j)-6. The treatment is similar to the rules for pre-consolidation losses: Hennessey, above note 22, paragraph 18.03[3].

\(^{97}\) Subpart FE ITA2007. The regime also applies to other types of taxpayers including individuals and trusts. Special rules apply to foreign-owned banks.

\(^{98}\) Section FE 5(1)(a) ITA2007. Similarly, the 110% threshold is defined in terms of the “worldwide group” that the company belongs, and is computed under the accounting consolidation principles: section FE 5(1)(b) ITA2007.

\(^{99}\) Section FE 14(1) ITA2007.

\(^{100}\) Section FE 27(2) ITA2007.
most cases, a consolidated group would be a subset of its "New Zealand group" as illustrated in Diagram 26 below:

**Diagram 26 Definitions of groups under the consolidation and thin capitalisation regimes in New Zealand**

In other words, no special rule is required to apply the thin capitalisation regime to a consolidated group in New Zealand.

The issue is put beyond doubt as the New Zealand tax law explicitly stipulates that it applies to members of a consolidated group "as if they were a single company, including its treatment for the ... purposes [of] a provision [which] sets a limit or provides a threshold, and its application depends on whether or not something is more or less than the limit or threshold" (emphasis added).\(^\text{101}\)

The thin capitalisation regime sets a limit for the interest deduction and

\(^{101}\) Section FM 2(1) ITA2007.
provides thresholds before it applies. It follows that the regime applies to a consolidated group as if it is a single taxpayer. 102

In summary, the difficulty of applying a thin capitalisation regime to a consolidated group depends on a number of factors:

(1) the design features of the thin capitalisation regime:
Factors include whether the regime offers alternative treatments for different categories of companies, whether it creates carry-forward tax attributes that can be brought into a consolidated group, and whether the regime is defined in terms of a “group” or “stand-alone company” basis.

(2) the single entity concept in the consolidation regime:
A pooling system in general allows an easier application of the thin capitalisation regime to a consolidated group. In contrast, a strong single entity concept that deviates significantly from the separate entity doctrine tends to pose more serious problems.

**9.3.7 Controlled foreign company regime**

This is another example of how the design features of a tax regime can facilitate simpler application to a consolidated group. A key structural element of a controlled foreign company (“CFC”) regime is the definition of “controlled foreign company”. In general, the regime is triggered if, among other things, a resident, *together with its related parties*, controls a non-resident company. In other words, CFC regimes are designed to operate

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102 Both New Zealand and the U.S. adopt the “group” approach in their thin capitalisation regimes. However, the New Zealand rules are simpler as its thin cap regime simply denies deduction of the excessive interest expenses, but does not allow carry-forward of interest disallowed or excess limitation to future years. This design feature avoids the complicated rules in the U.S. to deal with carryover of these tax attributes into a consolidated group.
effectively on a group basis under the enterprise doctrine. Furthermore, as an anti-avoidance regime, the ownership threshold of a CFC regime (for example, 50 per cent) is often much lower than that of a consolidation regime (for example, 100 per cent). It follows that a CFC regime should apply comfortably to a consolidated group.

For example, the CFC regime in Australia defines “control” in terms of direct and indirect interests held by a resident and its associates.\(^{103}\) “Associates” of a company is defined for CFC purposes to include:\(^ {104}\)

1. another company that has sufficient influence on it or holds a majority voting interest in it; and
2. another company on which it has sufficient influence, or in which it holds a majority voting interest.

Though the definition of control is technically different from that of the consolidation regime,\(^ {105}\) in practice, given the 100 per cent ownership threshold requirement in consolidation, a consolidated company would most likely be an “associate” of other group members. Therefore, the election to consolidate in general do not affect whether a group member has a CFC or not.

9.4 Interactions with another consolidation regime

A consolidation regime in a country may interact with its counterpart in another country, which can result in double taxation or deduction. Given that

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\(^{103}\) Section 340, ITAA1936.

\(^{104}\) Section 318, ITAA1936.

\(^{105}\) In particular, the definition in consolidation is in terms of shareholdings, instead of significant influence or voting interests. For more discussion of the issues, see Chapter 5 Section 5.5.
most consolidation regimes are elective, double taxation is unlikely for a well-advised group in practice. In contrast, the double dip issue is a genuine concern.

Measures to deal with this issue can be classified broadly into two main policies: (1) reliance on tie-breaker rules in tax treaties; and (2) specific domestic anti-avoidance provisions.

The first policy deals with dual resident companies and relies on tie-breaker rules in treaties. If a company is a resident in two countries under their respective domestic tax law, in most cases a tie-breaker rule in the treaty between the two countries determines its residence in one of the countries for treaty purposes. Consolidation regimes in many countries exclude dual resident companies that are regarded as non-residents under treaty tie-breaker rules.106 This policy prevents these companies from being consolidated members in both countries at the same time, thus avoiding the double dip issue.

This policy is relatively simple. Relying on existing treaties avoids additional domestic tax provisions to deal with the double dip issue. However, it is not effective to deal with double dip by hybrid entities, which is a resident company in one country but regarded as a transparent entity in the other. For example, a company that is a resident in Australia under the Australian domestic tax law may be treated as a foreign branch of a U.S. group under the “check-the-box” regime in the U.S.107

106 Examples include Australia, Italy, the Netherlands and New Zealand. For more discussion of the issue, see Chapter 5 Section 5.2.
107 O’Donnell & Spence, above note 46, at 142.
The second policy to deal with the double dip issue is to have specific anti-avoidance provisions in the domestic tax law. A typical example is the dual consolidated loss rules in the U.S.\textsuperscript{108} In general, a dual consolidated loss incurred by a U.S. domestic corporation – which is also taxed on a residence basis in another country – can not be used to offset against taxable income of any other consolidated members.\textsuperscript{109} A separate unit of a U.S. corporation (including foreign branches and hybrid entities) are treated for the purposes of the rules as a wholly owned subsidiary of the corporation.\textsuperscript{110}

In contrast to the policy of outright exclusion from consolidation of dual resident companies that are regarded as non-residents under treaty, the U.S. allows such companies into a consolidated group. However, their losses may be quarantined under the dual consolidated loss rules.

The dual consolidated loss rules are more comprehensive than the policy of relying on treaty tie-breaker rules. It applies not only to dual resident corporations, but also hybrid entities. For example, it applies in the situation depicted in Diagram 27 below:

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\textsuperscript{108} IRC s.1503(d) and Reg. 1.1503-2. The rules were introduced in 1986. For a brief history of the rules, see Hennessey, above note 22, paragraph 18.01[1].

\textsuperscript{109} In particular, the dual consolidated loss in subject to the Separate Return Limitation Year ("SRLY") rules: Reg. 1.1503-2(d)(2)(i). There are a number of exceptions to the dual consolidated loss rules. For example, a consolidated group may elect to be bound by an agreement with the IRS that, among other things, include an undertaking that "no portion of the dual resident corporation's or separate unit's losses ... has been, or will be, used to offset the income of any other person under the income tax laws of a foreign country": Reg. 1.1503-2(g)(2). The dual consolidated loss may be recaptured, and interest will be paid, in a number of triggering events, including the use of the loss by another entity in a foreign country: Reg. 1.1503-2(g)(2)(iii).

\textsuperscript{110} IRC s.1503(d)(3) and Reg. 1.1503-2(b)(1) & 1.1503-2(c)(3)&(4).

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In this case, the loss of S2 would not be allowed to offset against the taxable income of P and S1. The dual consolidated loss rules also apply to PEs of U.S. corporations, if for example the PE is the head entity of a consolidated group in France as depicted in Diagram 28 below:111

111 This example is based on Example 1 in Reg. 1.1503-2(c)(16).
Diagram 28 The dual consolidated loss rules in the United States – PE

The dual consolidated loss rules would prevent the losses incurred by the PE from being claimed by the group in both the U.S. and France.

The advantages of a specific anti-avoidance provision in the domestic tax law to deal with the double dip issue include: (1) it does not have to rely on treaty tie-breaker rules; and (2) it can be designed to deal more effectively with
hybrid entities and other particular situations specific to a country’s tax regimes. There is a price to pay for these advantages: complexity. The dual consolidated loss rules in the U.S. are very complex.\textsuperscript{112}

9.5 Conclusion

This chapter analyses a number of issues arising from the interactions between the consolidation regimes in the eight countries and other parts of the income tax systems. The enterprise doctrine – under which a consolidated corporate group is treated as one single taxpayer – creates tension with other regimes that in general are designed to operate under the separate entity doctrine.

One of the common sources of problems is the “mismatch of taxpayers”, namely whether the other income tax regimes can operate properly on a consolidated group whose members to various extents have lost their separate identities for income tax purposes. The analysis suggests that a number of factors affect how easily the other regimes can be applied to consolidated groups.

First, a stronger application of the enterprise doctrine in a consolidation regime tends to imply a more difficult application of other tax regimes to a consolidated group. The enterprise doctrine and the separate entity doctrine are inherently incompatible. For instance, the tax authorities in Australia have to make selective and inconsistent overrides of the single entity concept before

the other tax regimes can work properly on intra-group assets between consolidated group members. The Dutch loan forgiveness regime which exempts from tax the amount of loan forgiven can apply properly to a consolidated group only with a specific override of the enterprise doctrine. The override is necessary to protect the original objective of the loan forgiveness regime, and to avoid unintended consequences. The thin capitalisation regime in Italy also meshes better with its consolidation regime — which is a pooling system — than its counterpart in Australia.

Second, if the other income tax regime is designed to work on a group basis, it tends to work more comfortably with a consolidated group. For example, the New Zealand thin capitalisation rules are designed to operate based on thresholds that are determined on a “group” basis. Given that the definition of a “group” in the regime is to a large extent consistent with that of the consolidated group, the regime applies easily to consolidated groups. The CFC regimes serve as another example of a consistent application of the enterprise doctrine in both consolidation and other income tax regimes, alleviating potential problems arising from their interactions.

Third, if the other tax regime applies different treatments to different categories of companies, it tends to have problems applying to a consolidated group which is treated as one single taxpayer. For example, the Australian thin capitalisation regime stipulates different treatments for different categories of companies. The differential treatments to each of the consolidated group members are incompatible with the strong single entity rule under which the whole consolidated group is deemed to be a single company, namely the parent company. Specific statutory overrides are required over the general categorisation rules in the thin capitalisation regimes. In contrast, the experience in Italy and the U.S. suggests that a
regime with a consistent treatment to all companies would apply to consolidated groups more comfortably.

Problems can also arise from applying tax treaties to consolidated group members. Whether a consolidated subsidiary is a “resident” of a country for tax treaty purposes may depend on, among other things, whether the company is still liable to tax under the consolidation regime. The Netherlands had to amend its consolidation legislation in 2003 to ensure that consolidated subsidiaries remain “liable to tax. The situation is less clear in Australia and Japan. Depending on the definition of resident in a particular treaty, there is an exposure that consolidated subsidiaries may not be “liable to tax”, and thus cease to be a resident for treaty purposes. In contrast, in New Zealand all consolidated group members are jointly and severally liable to the consolidated tax liability. This seems to be the simple way to avoid the “liable to tax” exposure.

The exclusion of PEs of non-residents from consolidation may be contrary to the non-discrimination article in tax treaties. The EC Treaty, in particular the freedom of establishment principle, imposes additional pressure on consolidation regimes of the EU countries. This is reflected in the more liberal rules for PEs in the European consolidation regimes. In contrast, the exclusion of non-residents from consolidation does not appear to pose serious concerns in terms of the non-discrimination article. The exclusion of non-resident companies is based on their residence instead of their “nationality” (for example, the place of incorporation), and thus is unlikely to be regarded as in breach of the article. Nevertheless, the exclusion of non-resident companies from consolidation in the EU countries remains under pressure from the EC Treaty.
Chapter 9 Interactions with Other Parts of Income Tax System

The dual status of PEs included in a consolidated group poses some interesting issues. The experience in the Netherlands suggest that specific provisions may be required to clarify the tax treatment of transactions between the non-resident head office of a consolidated PE and other members of the consolidated group.

Interactions between two consolidation regimes in different countries can create the double dip issue. This issue may be resolved by relying on tax treaty’s tie-breaker rules to prevent a dual resident company from being a consolidated group member in both countries. This policy option is relatively simple as no specific anti-avoidance provision is required in the domestic tax law. However, it is only effective for double dip structures involving dual resident companies, but not other kinds of entities such as hybrid entities.

An alternative policy option to deal with the double dip issue is a specific anti-avoidance regime, such as the U.S. dual consolidated loss regime. It represents a more comprehensive regime, capable of dealing with the issue arising from not only dual resident companies, but also hybrid entities and PEs. The disadvantage of this policy option is that the rules tend to be very complex.

The next chapter builds on the comparative materials in Chapters 4 to 8 and provides an overall comparative analysis of the key structural elements of consolidation regimes in the eight countries, with the objective to search for a model consolidation regime.
10.1 Introduction

This chapter provides an overall comparative analysis of the consolidation regimes in Australia, France, Italy, Japan, the Netherlands, New Zealand, Spain and the United States. They are the eight countries that, by the end of 2009, have introduced consolidation regimes in their income tax systems. The following ten key structural elements of a consolidation regime, and the issues arising from the interactions between consolidation regimes and other parts of the income tax systems, are analysed in the preceding six chapters:¹

(1) The single entity concept;
(2) Consolidation of group results;
(3) Liability to tax;
(4) Election to consolidate;
(5) Definition of a group;
(6) The “all in” rule;
(7) Treatment of pre-consolidation losses;
(8) Treatment of consolidated group’s losses;
(9) Treatment of assets; and

¹ For the rationales for the order of these ten key structural elements, see Chapter 1 Section 1.5.3.
(10) Treatment of intra-group shareholdings.

In this chapter, the alternative policy options for the ten key structural elements are compared and evaluated, with the intention of identifying a model consolidation regime. For the purposes of this comparative analysis, it is assumed that the reader is familiar with the relevant detailed tax rules of the eight countries discussed in the preceding six chapters. Readers may find it convenient from time to time to refer to the comparison tables at the end of each of those six chapters. Furthermore, the policy objectives of introducing the consolidation regime in each of the eight countries – which often provide the underlying rationale for the policy options adopted in the countries – are analysed in Chapter 4 Section 4.2. They are discussed in the comparative analysis in this chapter wherever appropriate.

The comparative analysis in this chapter serves another purpose. Consolidation regimes in all eight countries apply, to considerably different extents, the enterprise doctrine under which a corporate group is treated as one single taxpayer. The eight regimes represent a spectrum, ranging from the pooling system (for example, in France) – under which each consolidated member remains to a large extent as a separate individual entity – to the "asset-based" model in Australia, under which all consolidated subsidiaries are deemed to have become divisions of the parent company and ceased to exist for income tax purposes. The comparative analysis provides an opportunity to answer the important question of whether a stronger application of the doctrine necessarily implies a better consolidation regime on policy grounds.

It is important for tax policy makers in a country to be aware of the policy solutions adopted in other countries. This applies not only for the eight

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2 The main tax policy objectives – including simplicity, neutrality and competitiveness – used to evaluate the alternative policy options are discussed in Chapter 2 Section 2.3.3.
countries if they need to fine-tune their consolidation regimes, but also for other countries that contemplate the introduction of a consolidation regime. Experience suggests that once a consolidation regime is introduced, there are unlikely to be major structural changes in the regime. It is therefore important for countries to get the regime right when it is first introduced. Of course, a policy that is effective and appropriate for one country may not be so for another country. Transplanting a policy solution from another country without due consideration of the local circumstances and constraints can be hazardous. Nevertheless, important lessons may be learnt from the experience of alternative policy options adopted in other countries.

This chapter first compares and evaluates alternative policy options in the eight countries in respect of the ten key structural elements of a consolidation regime. The findings of the comparative analysis are summarised in Section 10.3 below and are employed in the search for a model consolidation regime. The chapter concludes by arguing that a stronger application of the enterprise doctrine does not necessarily produce a better consolidation regime on policy grounds, especially with respect to the tax policy objective of simplicity.

3 South Korea is the newest member to the group of countries with a consolidation regime, with its consolidation regime becoming effective in 2010. Some countries are considering the introduction of the regime. For example, the Canadian government announced in its 2010 Budget that it will consider, among other things, the introduction of a consolidation regime: Minister of Finance, *Budget 2010: Leading the Way on Jobs and Growth* (available at www.fin.gc.ca), at 386. Pakistan issued detailed consolidation rules for public comments in April 2009: IBFD, *Tax News Service Online* dated 14 April 2009 (available at www.ibfd.org), accessed on 19 September 2009.

10.2 Policy options for key structural elements of a consolidation regime

10.2.1 Core rule: the single entity concept

In all the eight countries, consolidation regimes in general treat corporate groups as one single entity under the enterprise doctrine. However, they demonstrate considerable variation in the extent to which this "single entity concept" is applied. In some countries (such as France), the concept means that while a consolidated group computes consolidated group profit and files a single tax return for the group, each of the consolidated group members remains to a large extent as a separate entity for income tax purposes. In other countries (such as Australia), the single entity concept represents a stronger application of the enterprise doctrine. In addition to filing a consolidated tax return, the concept means that each consolidated subsidiary loses its separate identity for income tax purposes and is treated as a division of the parent company.

The comparative analysis of the eight consolidation regimes reveals broadly three policy options of how a consolidated group is treated as a single entity:

(i) pooling;
(ii) attribution; and
(iii) absorption.

The pooling system is the predominant policy option of the single entity concept in the eight countries. All of them except Australia and the Netherlands apply this system. Under the pooling system, the parent company and its subsidiaries in a consolidated group remain to be treated to a large extent as separate entities for income tax purposes. The taxable income or loss of each group member in general is computed on an individual basis. The
results are then aggregated at the group level and adjusted for intra-group transactions to arrive at the consolidated taxable income or loss.

The major advantage of this policy option is simplicity. Most of the existing tax rules for companies are designed under the traditional separate entity doctrine, under which each company is treated as a separate taxpayer. They can therefore be applied comfortably to consolidated group members under a pooling system which to a large extent preserves this separate entity treatment. The adjustments for intra-group transactions in general do not pose serious problems in practice, possibly due to the fact that most groups are familiar with similar adjustments required under the accounting consolidation rules. The interactions between the consolidation and other income tax regimes are also simpler, as the former embraces to a large extent the separate entity doctrine which is the fundamental underlying principle of the latter.

A related policy issue is whether the individual tax computations of consolidated group members under the pooling system should be prepared on a stand-alone or group basis. For example, an expenditure of a subsidiary may be regarded as capital in nature on a stand-alone basis and thus not deductible. However, if the item is examined on a group basis, facts and circumstances of other group members are taken into consideration. It may then be judged to have a revenue character and thus deductible.

In all of the six countries except New Zealand, consolidation regimes adopt the "stand-alone" basis. Each subsidiary prepares its tax computation on a stand-alone basis before aggregating at the group level. Taxability and deductibility of various items are generally determined as if the subsidiary were a stand-alone unconsolidated company. Although there are exceptions to the general rule, the stand-alone basis is the predominant approach.
Chapter 10 Comparative Analysis of Eight Consolidation Regimes

In contrast, each group company prepares its tax computation on a group basis in New Zealand. When calculating the taxable income of a group member for consolidation purposes, measures are in place to ensure that a consolidated group is generally liable to income tax as if it were a single company. Income derived by a group member is treated as taxable if the income would be taxable to the consolidated group if it were one company, even though it would otherwise be non-taxable. Similar rules apply to expenditures. This policy represents a stronger application of the enterprise doctrine.

In practice, the stand-alone basis implies lower compliance costs than the group basis. Individual tax computation of a consolidated company can be prepared as if it has not consolidated. Ordinary tax rules for companies can be applied, avoiding re-assessing taxability and deductibility of each income and expense item of a consolidated member by considering the facts and circumstances of other group members.

The Netherlands is the only country adopting the attribution policy option in its consolidation regime. Compared with the pooling system, this policy represents a stronger application of the enterprise doctrine. Assets, liabilities and activities of consolidated subsidiaries are attributed to the parent company. In other words, income and expenses of the subsidiaries are deemed to be those of the parent company, thus achieving the aggregation of taxable income and losses of the group members. One important feature of this option is that the subsidiaries remain to be treated as separate individual companies for income tax purposes. This has proved to be important with respect to the application of tax treaties for these subsidiaries.5

Australia is the only country with the “absorption” policy. This single entity concept, known as the “single entity rule” (“SER”), represents the strongest

5 See discussion in Chapter 4 Section 4.3.
application of the enterprise doctrine to date. It is a bold attempt to push the logic of the doctrine to an unprecedented level. Consolidated subsidiaries are deemed to have become divisions of the parent company, and to have *ceased to exist* as individual companies for income tax purposes. Assets of subsidiaries are deemed to be held directly by the parent company.

This strong single entity concept has significant implications. Under the SER, the consolidation regime has a couple of distinct attractions. First, unlike most other consolidation regimes, intra-group asset transfers within a consolidated group are ignored completely. The transfers not only would have no immediate tax implication, but also would not require tracing of asset movements, keeping record of any deferred gain or loss, or recapturing the gain or loss when either the transferor or transferee leaves the group. Second, again in contrast to most other consolidation regimes, pre-consolidation losses of a joining subsidiary in general are transferred to and can be used by the parent company, *without* the need to compute the subsidiary’s “stand-alone” taxable income every year. In other words, once a group enters the consolidation regime, it is a wonderful tax-friendly world to be in.

However, the price to pay for these advantages is high. The impact of the strong SER is significant and dictates the following tax implications:

(i) Once a subsidiary joins a consolidated group, it loses forever its right to claim its pre-consolidation losses both during consolidation and after it leaves the group.

(ii) The original cost bases of many assets (including deprecating and capital assets) of a joining subsidiary are erased forever once it joins a consolidated group. They are replaced by the “reset” cost bases computed under the complex and problematic tax cost setting rules. This
is so even if the company continues to own the assets without any intra-group transfers during consolidation.

(iii) The original cost bases of shares in a joining subsidiary are also erased forever upon consolidation. They are reconstituted at leaving time based on the cost bases of assets (including “reset” cost bases) that the company holds at that time.

Once a subsidiary joins a consolidated group in Australia, it is a road of no return for the above tax attributes. These tax attributes are changed or erased forever. There is no mechanism to revert back to the original figures when the company leaves the group.

The rules on pre-consolidation losses and resetting cost bases are problematic and highly complex.6 Another problem of the strong SER is the difficult interactions between the consolidation regime and other parts of the income tax regime. Most regimes in the tax law are designed under the traditional separate entity doctrine, which by definition contradicts the enterprise doctrine. The strong SER renders the application of other tax regimes to consolidated groups more difficult.

10.2.2 Consolidation of group results
This is the only key structural element that exhibits a consistent policy in all the eight countries. Each of them adopts the full consolidation policy for group members’ taxable income and losses, instead of the proportional consolidation policy. This is so even if a parent company holds less than 100 per cent interest in a subsidiary. For instance, in Italy, despite the low ownership threshold of 50 per cent, the whole amount of taxable income or loss of a subsidiary is consolidated. This full consolidation policy is

6 See discussion of these rules in the following sections.
consistent with the enterprise doctrine under which a corporate group under the common control of a parent company is treated as a single taxable unit. It follows that consolidated subsidiaries should be treated as part of the single taxable unit with all their taxable income and losses included in the tax base of the consolidated group.

10.2.3 Liability to tax

All the eight countries, except France and Italy, impose joint and several liability on group members for the consolidated group’s tax liability. For administrative convenience, most countries impose primary responsibility on the parent company to pay the group’s tax liability while at the same time ensuring that all group members are jointly and severally liable if the parent company defaults. This policy is not only consistent with the enterprise doctrine, but also serves well the fundamental objective of a tax system: revenue collection. France and Italy have a different policy: while the parent company of a consolidated group is responsible for the payment of the group’s consolidated tax liability, each group member is jointly and severally liable for the payment of the group tax to the extent of the tax liability of the company on a stand-alone basis. This policy reflects a relatively strong influence of the separate entity doctrine in the two consolidation regimes.

10.2.4 Election to consolidate

All the eight countries allow corporate groups to elect to consolidate; none of their consolidation regimes is mandatory. However, they are divided on the issue of whether the election to consolidate is revocable or not. Three countries – namely the Netherlands, New Zealand and Spain – allow a group to revoke the election. Four countries – namely France, Italy, Japan and the U.S. – in general do not allow a group to revoke the election. However, the relatively short terms of an election in France (five years) and Italy (three years) represent a less rigorous anti-avoidance policy objective than in the
other two countries. The remaining country Australia fails to have a consistent policy on this issue. An election to consolidate is irrevocable for domestically-owned groups, but is effectively revocable for foreign-owned groups.

The divergent policies on this key structural element demonstrate the difficult compromise that policy makers have to make between competing policy objectives. The policy choice between revocable and irrevocable elections depends on the trade-off between anti-avoidance – which would suggest an irrevocable election – and competitiveness which would suggest that the election be revocable.

10.2.5 Definition of a group

This key structural element consists of two major factors:

   (i) entities eligible to consolidate; and
   (ii) ownership requirements.

Entities eligible to consolidate

With respect to the first major factor of eligible entities to consolidate, all the eight countries exclude non-resident companies from their consolidation regimes. Under the enterprise doctrine, a corporate group under the common control of a parent company should be treated as one single enterprise. The application of the doctrine in practice is always subject to constraints and compromises. For instance, the differential spans between the economic substance of a corporate group and the political jurisdictions create tension in the definition of a group eligible to consolidate. Most countries adopt a regime restricted to resident companies, reflecting supremacy of political reality that extending general residence taxing rights to non-resident companies is unacceptable. Extending consolidation to non-resident entities
also raises revenue and anti-avoidance concerns. Therefore, most consolidation regimes are restricted to resident company groups. Exceptions are rare.  

However, the eight countries are divided on the issue of whether a PE of a non-resident company is eligible to consolidate. All the four EU countries – primarily in response to the pressure from some ECJ decisions – in general allow PEs to join consolidation, but not so for the other four non-EU countries. Among the four EU countries, the policy is inconsistent between parent company and subsidiary. While a PE can be either the parent company or a subsidiary member in a consolidated group in France and the Netherlands, Italy and Spain allow a PE to be only the parent company but not a subsidiary member.

All the eight countries except Italy and New Zealand exclude subsidiaries owned indirectly through non-group members. This policy deviates from the enterprise doctrine, but can be justified on anti-avoidance grounds.

The policies in the eight countries are similarly convergent with respect to the issue of “brother/sister companies”. All of them, except Australia and New Zealand, do not allow brother/sister companies to consolidate without a parent company. New Zealand has the most flexible rule on this issue: it is the only country that in general allows brother-sister companies to consolidate. Australia again has inconsistent policies between domestically-owned and foreign-owned groups. It requires the top parent company to be in a consolidated group for domestically-owned groups, but allows brother/sister companies to consolidate under the MEC group rules for foreign-owned groups. The policy objective of competitiveness appears to have a significant

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7 France and Italy have worldwide consolidation regimes, but they have very limited use in practice. See discussion of the regimes in Chapter 3 Section 3.3.
influence in shaping the policies of “brother/sister companies” in these two countries.

In contrast, the eight countries are divided on the issue of whether the top parent company must be included in consolidation. Four countries – Australia, France, Japan and Spain – require this, while the other four countries do not. Such divergence in policies again illustrates the difficult compromise between two competing policy objectives: anti-avoidance and competitiveness.

Ownership requirements
The other major factor of the key structural element of “definition of a group” is the ownership requirements. “Control” is a crucial concept in the enterprise doctrine and an important element in the definition of a group. It consists of two critical factors:

(i) the ownership threshold: for example, should the threshold represent “perfect control” (that is, 100%), or just a bare majority (that is, more than 50%), or some level in between?

(ii) the factors of “control”: what should be the factors of “control” in the definition of a group? Should it be shareholding, voting rights, value of shares, or combinations of these factors? The factors in the definition should be relevant in contributing to “control”, easy to measure and to police.

In practice, it is not easy to provide a simple and effective definition of “control”. A bright line definition – for example, a minimum percentage of voting rights – may be relatively simple, but may not be effective. “Control” can be established by various means, such as options and convertible
securities, control over the composition of the board of directors or key executives, or special shareholders’ agreements. A more general definition — for example *de facto* control — may be more effective to capture a "control" relationship, but is not easy to administer as it is “too uncertain and unpredictable”. Most countries adopt the bright-line option, and protect it with supplementary tests and/or anti-avoidance provisions.

(i) Ownership threshold

With respect to the ownership threshold, the comparative analysis of the eight countries reveals broadly two alternative policies in their consolidation regimes:

(a) "Substantially 100%":

Five of the eight countries adopt this option, namely Australia, France, Japan, the Netherlands and New Zealand. In particular, France and the Netherlands have a 95 per cent threshold, while the other three countries have 100 per cent. The five per cent leeway allowed in France and the Netherlands is designed to cater for employee share schemes or small shareholdings that the parent company fails to purchase in an acquisition. In the other three countries, shares held under an employee share scheme — up to a maximum (namely, one per cent in Australia; five per cent in Japan and three per cent in New Zealand) — are specifically ignored for the purpose of the ownership threshold test.

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8 For a detailed analysis of the definition of control in different regimes, see Antony Ting, "Definition of Control in Consolidation and Controlled Foreign Company Regimes: A Comparison between Australia, New Zealand and the US" (2006) 12(1) New Zealand Journal of Tax Policy 37.

9 Arnold, above note 4, at 417.

10 The threshold in the Netherlands was 100% before 2003.
The high threshold can be justified on the following grounds. First, under the enterprise doctrine, a subsidiary under the control of a parent company should be treated in a similar manner as a branch of the latter. In accordance with the neutrality principle, the parent company should wholly own the subsidiary without any minority interest. In other words, the threshold should be 100 per cent. Second, as loss offset among group members is likely to impact adversely on revenue, governments may try to minimise the impact by restricting access to the regime with a higher threshold. For example, the Dutch government was reluctant to lower the 95 per cent threshold because of revenue concerns. Third, the presence of a minority interest introduces complexity into the consolidation regimes. During the design phase of the Australian consolidation regime, U.S. officials specifically warned their Australian counterparts not to allow minority interest in subsidiaries as the U.S. does.

Corporate groups in practice do not have major objections to a high threshold. Given the significant benefit of intra-group loss offsetting and tax free asset transfers, it is reasonable to expect a strict ownership requirement to screen for eligible group members. Furthermore, in practice, most subsidiaries of corporate groups are wholly owned for commercial reasons. Therefore, a high threshold does not pose a significant obstacle to consolidation.

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11 Many countries allow a small percentage to be owned by employees through employee share schemes. This policy is pragmatic and reasonable, as this kind of holding in general would not significantly affect the control of the parent company over the subsidiary.


13 For example, in Australia, it was found that over 90 per cent of subsidiaries in listed corporate groups were wholly-owned subsidiaries: Ian M Ramsay and G Stapledon, “Corporate Groups in Australia” (2001) 29(1) Australian Business Law Review 7.
(b) "Substantially less than 100%":

Three countries have an ownership threshold substantially lower than 100 per cent: Italy (50 per cent), Spain (75 per cent)\(^{14}\) and the U.S. (80 per cent). The unusually low threshold of 50 per cent in Italy may be due to historical reasons.\(^{15}\) In Spain, the ownership threshold has fluctuated over the years. It was 50 per cent when the consolidation regime was introduced in 1977, increased substantially to 90 per cent in 1982, and reduced to 75 per cent in 2002. The ownership threshold in the U.S. consolidation regime has also evolved over the years, from "substantially all" shares in 1917 to the present 80 per cent threshold since 1954.\(^{16}\) The major problem with the relatively low threshold is the presence of minority interests in subsidiaries. The U.S. experience strongly suggests that the presence of a significant minority interest is not advisable.\(^{17}\)

(ii) Factors of control

The comparative analysis reveals considerable variations in the choice of "control" factors in the definition of a group among the eight countries. The two most common factors of control are shareholding and voting rights:

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\(^{14}\) The threshold is reduced to 70% for listed subsidiaries since 1 January 2010.

\(^{15}\) Before the consolidation regime was introduced, Italy had an "implicit" group taxation regime, known as the "excess imputation credit surrender" regime. In broad terms, the regime allowed intra-group loss utilisation by surrendering excess tax credits of a loss company to profitable related companies. The regime's ownership threshold was 50%. This perhaps has some bearing on the 50% ownership threshold in the consolidation regime.

\(^{16}\) When the regime was first introduced in 1917, it required that the parent company had to own "substantially all" the shares of another company. The threshold was changed to "95% of voting stock" in 1924. The test was again amended in 1942 to require ownership of 95% of voting power of all classes of shares and 95% of non-voting shares. The threshold was then reduced to 80% in 1954, designed to allow more companies to consolidate.

\(^{17}\) During the design phase of the Australian consolidation regime, U.S. officials specifically warned the Australian counterparts not to allow minority interest in subsidiaries as the U.S. does: Lehmann, above note 12, at 277.
(a) Shareholding:
The policy option of defining a group in terms of shareholdings is relatively simple to determine in practice but prone to abuse. It is therefore common for countries to supplement “shareholding” with other factors in the definition of a group.

All the eight countries except New Zealand and the U.S. adopt “shareholding” as a factor in their ownership requirements. However, they incorporate different degrees of protection to the factor.

Australia and Spain have no specific protection and adopt “shareholding” as the sole factor in the ownership requirement. In Australia, the ownership test focuses primarily on the legal form of ownership, and fails to consider the vital criteria of either voting rights or value of the interest. The test provides substantial potential for abuse. In Spain, to be eligible to consolidate, a parent company is required to have a direct or indirect interest of at least 75 per cent of the share capital of a subsidiary. Organisational or economic integration is not required. Voting rights are not relevant in the ownership test, thus suffering similar problems as in Australia.

In contrast, the other four countries that adopt “shareholding” as a factor in their ownership tests incorporate additional protections. France requires “voting rights”; the Netherlands requires “rights to profits”; while Italy requires both. Japan has a specific anti-avoidance provision targeting abuse of its consolidation regime.

(b) Voting right:
The “voting right” factor is designed to define a “control” relationship between the parent company and its subsidiaries. Four countries —
namely France, Italy, New Zealand and the U.S. – adopt this factor in their ownership requirements. While France and Italy also incorporate “shareholding” as another factor, New Zealand and the U.S. define their ownership tests primarily on the “voting right” factor and supplement it with a “value of share” factor. The latter is designed as an anti-avoidance measure to protect the “voting right” factor.

The analysis above reveals the divergent policies in the definitions of a group in the eight countries. It demonstrates that the particular policy choices of a country often represent difficult trade-offs between competing policies and conflicting constraints.

10.2.6 The “all in” rule
Under the enterprise doctrine, a corporate group under the common control of a parent company should be treated as one single enterprise. It implies that all group members should be included in a consolidated group. In practice, the application of the enterprise doctrine may be restricted by other policy objectives that governments deem important. For example, the policy objective of competitiveness may trump the enterprise doctrine. In that case, the government may decide to allow “cherry-picking” of subsidiaries to join a consolidated group. The policy is flexible to taxpayer, but deviates from the enterprise doctrine and is prone to abuse.

The comparative analysis of the eight countries reveals no predominant policy on this key structural element. Four countries – namely France, Italy, the Netherlands and New Zealand – allow “cherry-picking” of subsidiaries. Three countries – Japan, Spain and the United States – impose the “all in” rule. Australia fails to have a consistent policy. It imposes the “all in” rule for domestically-owned consolidated groups, but allows cherry-picking of subgroups owned by foreign parent companies.
It is difficult to determine which approach is better. The diverse policy choices among the eight countries reflect the difficult compromises governments have to make between competing policy objectives. On one hand, the “all in” rule serves an anti-avoidance objective by insisting all eligible group companies join a consolidated group. On the other hand, allowing cherry-picking promotes “competitiveness” of consolidation regimes.

10.2.7 Treatment of pre-consolidation losses
The ability to offset income and losses among consolidated group members is the most significant advantage of consolidation. All eight countries allow intra-group offset of losses incurred by group members during consolidation. However, the treatments of pre-consolidation losses at joining time and consolidated group losses at leaving time are more varied.

The issue of pre-consolidation losses raises the difficult question of how losses incurred by a subsidiary before joining time should be treated. It is basically an issue dealing with the transition between the enterprise and separate entity doctrines. At joining time, the enterprise doctrine implies that the subsidiary becomes part of the enterprise controlled by the parent company. Its taxable income and losses generated during consolidation should be treated as those generated by the enterprise as a whole. However, pre-consolidation losses are incurred by a subsidiary when it is treated as a separate taxpayer under the separate entity doctrine. This begs the question of whether pre-consolidation losses of a subsidiary should be allowed to offset against a consolidated group’s taxable income.
The comparative analysis reveals three alternative policy options for the pre-consolidation losses issue.\(^{18}\)

\((i)\) Quarantine:
In all the eight countries except Australia and Japan,\(^\text{19}\) pre-consolidation losses of a joining subsidiary are quarantined. This policy option represents a clear reflection of the transition between the enterprise and separate entity doctrines. Under this option, pre-consolidation losses incurred by a subsidiary are quarantined and can be used to offset only taxable income of the company. All of these six countries except the Netherlands adopt the pooling system, which is a logical companion of the quarantine policy. Under a pooling system, a consolidated subsidiary remains to a large extent as a separate entity for income tax purposes. This is a pre-requisite for the quarantine policy.\(^{20}\)

A related policy issue is whether the pre-consolidation losses should be applied before or after aggregation of the group members' taxable income and losses. If the pre-consolidation losses are quarantined, the question is whether they should be available for offset before or after other group members' losses that are incurred during consolidation. This issue also arises from the transition between the two doctrines. Pre-consolidation losses are generated under the separate entity doctrine. The issue is whether it follows that the doctrine should continue to apply to those losses and thus dictate that the losses be offset first against

\(^{18}\) Theoretically, another alternative policy is to suspend pre-consolidation losses of a subsidiary during consolidation, and revert them back to the company when it leaves the consolidated group. However, in practice, none of the eight countries adopts this policy, possibly due to (i) undesirable deferral of loss utilisation for corporate groups; and (ii) the possibility of loss expiry (unless losses can be carried forward indefinitely in a country) or unusable losses if the subsidiary never leaves the group.

\(^{19}\) The rule in Japan has been relaxed since 1 October 2010 in certain circumstances: see subsection (iii) below.

\(^{20}\) For more detailed discussion of the quarantine policy, see Chapter 6 Section 6.2.
taxable income generated by the company before group losses, or the pre-consolidation losses should be offset first against the group’s taxable income under the enterprise doctrine.

The six countries that adopt the quarantine policy are divided between two different approaches:

(a) Offset before aggregation:
Three countries adopt the “offset before aggregation” option, namely France, Italy and New Zealand. Under this option, pre-consolidation losses of a subsidiary are applied first to offset taxable income of the company. Remaining taxable income (if any) would then be pooled together with the results of other group members to arrive at the group’s consolidated taxable income or loss.

The advantage of this option is simplicity. The pre-consolidation losses are determined and carried forward based on the general rules applicable to company losses. The policy option may also have tax implications in countries that impose a time limit on the carry-forward of losses. For instance, in Italy losses in general can be carried forward for a maximum of five years. The “offset before aggregation” policy allows a faster use rate of pre-consolidation losses, thus reducing the risk of loss expiry. In contrast, loss expiry is a non-issue in France and New Zealand, as the two countries in general allow losses to be carried forward indefinitely.

(b) Offset after aggregation:
The Netherlands, Spain and the U.S. adopt the reverse order. Pre-consolidation losses of a subsidiary are available for offset only after the taxable income of the company is aggregated with other group members’ results. It implies that the subsidiary can use the pre-consolidation losses only if the group as a whole has net taxable income.

The main disadvantage of this policy option is complexity. Experience of the three countries suggests that the apportionment rules of allocating the group’s net taxable income to a particular subsidiary tend to be complicated. Another potential problem of this policy is the risk of loss expiry. Pre-consolidation losses can be used only if the group as a whole has net taxable income, even if the subsidiary has taxable income on a stand-alone basis. All three countries adopting this policy option have loss carry-forward time limits. It thus appears that the risk of loss expiry is not a major concern to policy-makers in the three countries. This is possibly due to the relatively long period of loss carry-forward allowed in these countries.

(ii) Irreversible transfer to parent company:

Australia has a unique policy on pre-consolidation losses. Under the strong single entity rule ("SER"), subsidiaries are effectively deemed to have ceased to exist during consolidation. This begs the question of how pre-consolidation losses of subsidiaries should be treated.

The deemed “disappearance” of subsidiaries under the SER means that the “quarantine” policy is not an option in Australia. The quarantine policy typically restricts the loss utilisation rate by allowing offset of

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21 The time limits are: 9 years in the Netherlands, 15 years in Spain and 20 years in the U.S.
pre-consolidation losses only against taxable income generated by the same subsidiary. However, the government believes that the deemed disappearance of subsidiaries during consolidation means that it is not possible to calculate a subsidiary’s taxable income on a stand-alone basis, thus rejecting the quarantine policy.

Australia had an important constraint in the design of its rules on pre-consolidation losses. Before the consolidation regime was introduced in 2002, Australia had a group loss relief regime which in broad terms allowed intra-group loss transfers among resident wholly owned group companies. This put pressure on the policy makers to come up with a model that would be at least as attractive as the old group loss relief regime. The pressure was more intense as most companies were denied access to the old group loss relief regime after the introduction of the consolidation regime.22

Australia decided to allow transfer of pre-consolidation losses of subsidiaries to the parent company upon consolidation. The transfer is not reversed when the subsidiary leaves the group. Pre-consolidation losses of a subsidiary remain with the parent company forever. The policy of transferring pre-consolidation losses to a parent company presents a serious problem to the government: unrestricted utilisation of such transferred losses would have significant revenue impact. The solution is an invented concept: the available fraction (“AF”). In broad terms, pre-consolidation losses of a joining subsidiary are assigned an AF which is calculated based on the ratio of the market value of the subsidiary to that of the consolidated group at the joining time.

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22 New Zealand faced a similar constraint in its design of consolidation regime, but came up with a more flexible and taxpayer-friendly regime: both consolidation and group loss relief regimes co-exist.
maximum amount of the losses that the parent company may use in an income year is equal to the product of the AF and the group’s consolidated taxable income for that year.

The Australian government claims that the objective of the AF rules is to reflect the loss use rate if the subsidiary has not joined the consolidated group. However, the questionable use of “market value” as a proxy for the actual tax positions of a company, and the failure to adjust the market valuations on a regular basis, prevent the AF rules from achieving the objective.

Nevertheless, if one accepts that the most important objective of the AF rules is to restrict the use rate of pre-consolidation losses, the mechanical AF calculations seem to serve that purpose well. This is especially so given that the AFs of a group can never be adjusted upwards under all adjustment events. It may be more accurate to describe the AF rules as simply a rough and arbitrary measure designed to allocate a group’s taxable income to individual group members for the purpose of controlling the use rates of pre-consolidation losses.

Ironically, another advantage of the AF rules is due to its arbitrariness. In comparison with other countries, specific anti-avoidance provisions are not required in Australia to prevent abuse of loss offset rules under the quarantine policy.23

It is doubtful if this advantage is sufficient to justify the problematic AF rules, the outcome of which is detached from the actual circumstances of

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23 For instance, specific anti-avoidance provisions are required in Italy and the Netherlands to prevent accelerating utilisation of pre-consolidation losses of a company by intra-group transfer of assets with hidden reserves. This kind of provision is not necessary under the AF model, as the utilisation rate does not depend on a subsidiary’s individual taxable income.
a company. The AF of pre-consolidation losses of a subsidiary is determined at the joining time based on the prevailing market values of the company and the group, and is not subject to regular revaluation. Even if the subsidiary successfully turns around and makes a substantial profit during consolidation, the transferred losses are still subject to the old AF limit fixed at the joining time. The outcome is therefore very different from the more common quarantine policy. It also implies that the outcome would be very different if the subsidiary has not joined the consolidated group. This contradicts the government's claimed objective of the AF rules, and violates the neutrality principle. The rules also suffer from the heavy reliance on market valuations of subsidiaries and the group, which provides avoidance opportunities, and results in high compliance costs for taxpayers as well as policing costs for the tax authority.

(iii) Cancellation:
The approach in Japan is entirely different. Pre-consolidation losses of a subsidiary in general are cancelled upon joining a consolidated group.\(^{24}\) This is a very harsh policy. The losses are lost forever when the subsidiary joins a consolidated group. Tax avoidance is the primary reason for the harsh policy.

The cancellation of pre-consolidation losses of joining subsidiaries is a major disincentive for corporate groups in Japan to elect for consolidation. In fact, the Japanese government did not appear to be too enthusiastic about the consolidation regime. Other policies suggesting this attitude include the deemed disposal of certain assets at market value.

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\(^ {24}\) This rule has been relaxed under the 2010 tax reform in Japan. Effective 1 April 2010, pre-consolidation losses of a joining subsidiary is subject to the quarantine policy provided, among other things, the subsidiary has been wholly-owned by the parent company for five years before the joining time: see Chapter 6 Section 6.2.1 for more detail.
at joining time, and the two per cent consolidation surcharge in addition to the normal corporate tax rate (imposed for the first two years after the introduction of the consolidation regime in 2002).

The cancellation policy is simple, avoiding complex rules to control the use rate of pre-consolidation losses. However, it violates the principle of neutrality. The tax outcome of an unconsolidated company with carried forward losses would be very different if it joins a consolidated group. In contrast, most other countries aim to allow offset of pre-consolidation losses of a subsidiary at a rate approximating that of the company that has not consolidated.

10.2.8 Treatment of group losses
This key structural element deals with the treatment of group losses during consolidation, at leaving time and upon de-consolidation.

During consolidation, all the eight countries in general apply the enterprise doctrine by treating group losses as those of a single company. The U.S. is unique in allowing group losses to be apportioned to a particular subsidiary for carry back or forward to its separate tax return years. The policy reflects a relatively strong influence of the separate entity doctrine in the U.S. consolidation regime.

The policies of the eight countries are less convergent on the treatment of group losses at leaving or de-consolidation time. At leaving time, group losses pose a similar transition problem as pre-consolidation losses, but in a "reverse" sense: how should group losses – that are generated under the enterprise doctrine – be treated when a subsidiary leaves a group when the separate entity doctrine applies again? During consolidation, the enterprise doctrine applies. It follows that overall losses of the group incurred during
consolidation belong to the group as a whole, instead of to individual members. It is reasonable therefore to quarantine those losses to the group, instead of allocating the losses to individual group members. However, the eight countries do not exhibit a clear preference for this policy option. There are two main policy options on this issue: "stay with group" and "apportionment".

(i) Stay with group:
Under this option, group losses stay with the consolidated group, even if a leaving subsidiary has contributed to the consolidated group losses. This option is consistent with the enterprise doctrine and in practice is simple to operate, as there is no need for complex allocation rules to apportion the consolidated group losses to a leaving subsidiary.

Five countries adopt this option, namely Australia, France, Italy, the Netherlands and New Zealand. However, the positions in Italy and the Netherlands are complicated by the option for consolidated groups to apply for apportionment. Both countries provide the flexibility that a consolidated group can apply for apportionment of the group's consolidated losses to a leaving subsidiary. This apportionment option increases the complexity of the regime.

(ii) Apportionment:
In Japan, Spain and the U.S., a group's consolidated losses are allocated to a leaving subsidiary. This option reflects a relatively strong influence of the separate entity doctrine and requires complex allocation rules to determine the amount of the consolidated group's losses that can be carried forward by the leaving subsidiary.
The eight countries are similarly divided on their policies of group losses at de-consolidation. Four countries – namely Australia, France, Italy and New Zealand – in general adopt the policy that group losses stay with the parent company upon de-consolidation. The other four countries – namely Japan, the Netherlands, Spain and the U.S. – apportion group losses to individual group members at that time.

In summary, policies on the treatment of losses – which is possibly the most important benefit of a consolidation regime – in the eight countries do not always converge. The countries are divided on the issues of (1) whether to offset pre-consolidation losses of a subsidiary before or after aggregating into the group result; (2) whether to allocate group losses to a leaving subsidiary; and (3) whether to allocate group losses to each group member at de-consolidation. The divergent policies reflect the difficult compromise between not only competing policy objectives, but also the two inherently conflicting enterprise and separate entity doctrines. With respect to the treatment of group losses at leaving time and deconsolidation, the policy option of “stay with group” and “stay with parent company” respectively is not only consistent with the enterprise doctrine, but also preferred for the policy objective of simplicity.

### 10.2.9 Treatment of assets (except intra-group shares)

#### (i) Assets at joining time

Tax free transfer of assets among consolidated group members is another significant advantage of consolidation. The basic problem at joining time is how the tax attributes of assets of a joining subsidiary should be treated when the company transits from being taxed under the separate entity doctrine to the enterprise doctrine. Pre-consolidation tax attributes of assets include their tax cost bases and unrealised gains (or losses) in the assets.
The comparative analysis of the eight countries reveals three alternative policy options for the treatment of assets (except intra-group shares) at joining time:

(a) Rollover:
All of the eight countries except Australia and Japan adopt this policy. There are no immediate tax implications for assets of subsidiaries at joining time. Under this policy, pre-consolidation tax attributes are rolled over to the consolidated group. Pre-consolidation assets of a joining subsidiary are treated as owned by the consolidated group at the original cost bases. Subsequent sale of these assets to third parties would be recognised by the group. The whole amount of gain or loss on disposal — including the amount attributable to the pre-consolidation period — is attributed to the group.

(b) Mark-to-market:
Japan is the only country that adopts this option on a general basis for fixed assets, land, securities held as capital assets, and monetary assets held by a joining subsidiary. The Netherlands adopts a general policy of rollover, except for intra-group shares and receivables which are marked-to-market at joining time.

Under this policy, assets are deemed to have been passed to the consolidated group at their market values. Unrealised gains or losses on assets owned by a subsidiary before the transition are recognised immediately. The cost bases of the assets to the consolidated group are their market values at the time of consolidation.

The mark-to-market policy is effectively a deemed sale at joining time, thus reflecting a clear transition from the separate entity doctrine to the

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25 The treatment of intra-group shareholdings is discussed separately below.
enterprise doctrine. However, in practice, it may not be welcomed by either governments or taxpayers. Immediate taxation of unrealised gains contradicts the realisation principle. It renders the consolidation regime less attractive. This option is therefore uncommon in practice. A strict application of such a rule also implies high compliance costs as market valuation of all assets is required at the joining time. In Japan, the rule is therefore subject to a number of exceptions, including assets of the parent company and subsidiaries owned by the parent company for more than five years.

(c) Reset cost bases:
Australia adopts the world's first “asset-based” model, primarily driven by the determination to deal with the dual cost bases issue. Unlike most European countries, Australia does not have a comprehensive domestic participation exemption regime for corporate equity. The dual cost bases issue therefore represents a serious challenge to the tax system, including double taxation of the same economic gain, double deduction of the same economic loss, and value shifting among group members. The government believes that the introduction of a consolidation regime was a valuable opportunity to deal with the problems. It adopted the strong SER in the consolidation regime effectively collapsing multiple levels of ownerships in a corporate group into one single level. In particular, all subsidiaries are deemed to have become divisions of the parent company, and their assets are deemed to be owned directly by the latter. By collapsing multiple levels of ownership into one, the dual cost bases issue becomes a non-issue within a consolidated group in Australia.26

26 However, consolidation can only deal with the dual cost bases issue in relation to corporate groups that elect to consolidate. The tax law still requires other specific provisions to deal with the issue for non-consolidated groups. In contrast, a comprehensive participation exemption would be a more comprehensive solution for all corporate groups.
Chapter 10 Comparative Analysis of Eight Consolidation Regimes

The adoption of the strong SER leads to the important issue of what should be the cost bases of subsidiaries' assets that are now deemed to be owned directly by the parent company. The government believed that the more common rollover policy was thus incompatible with its determination to collapse multiple levels of ownerships in a consolidated group into one. Instead, it chose the asset-based model. The decision was partly influenced by the experience of the "equity-based" model in the U.S.\textsuperscript{27}

However, the Australian model is not better than its U.S. counterpart in terms of simplicity. As shares in subsidiaries are deemed to have disappeared upon consolidation, a complex set of rules - known as the tax cost setting ("TCS") rules - are designed to push down the cost bases of shares to the underlying assets. Under the TCS rules, a subsidiary's liabilities (identified and measured under accounting rules) are added to the cost base of shares in the company and adjustments are made for certain profits and losses of the company to arrive at an amount known as the "allocable cost amount" ("ACA"). The ACA is then generally allocated to the assets in the subsidiary according to their market values at the joining time. The cost bases of many assets are "reset" at the joining time. The "reset" cost base replaces the "real" cost base forever and stays with the asset even if the subsidiary subsequently leaves the group.

The policy of allowing step-up basis under the TCS regime is surprisingly generous. It effectively allows converting part of share acquisition costs into depreciable cost bases, the extent of conversion

\textsuperscript{27} The policy-makers in Australia consulted with their counterparts in the U.S. on this particular issue. The latter advised strongly against adopting the U.S. equity-based model which requires ongoing complex equity tax basis adjustments for intra-group asset transfers during consolidation: Lehmann, above note 12, at 277.
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depending on the relative amount of depreciable assets of the subsidiary involved, their market values, and also the aggressiveness of taxpayers taking advantage of the rules. The step-up basis could also reduce gain on future disposal of capital assets.

The TCS rules are highly complex and problematic.\textsuperscript{28} Their design is based on a flawed theory. The resulting reset cost bases of assets can result in an artificial gain or loss, which can be duplicated at leaving time. The heavy reliance on market valuations of assets not only increases compliance costs of taxpayers and policing costs of the tax authority, but also provides ample avoidance opportunities.

\textit{(ii) Intra-group asset transfer during consolidation}

Under the enterprise doctrine, intra-group asset transfer during consolidation should have no immediate tax implications for the group. The transfer should be treated as if it is a transfer between divisions of a company. Among the eight countries, there are basically three policy options for this key structural element:

\textit{(a) Rollover:}\textsuperscript{29}

The rollover policy is the predominant option among the countries. All of the eight countries except Australia and Italy adopt this option. Italy originally also allowed rollover when its consolidation regime was introduced in 2004. However, the policy was abolished in 2008 and intra-group asset transfers within a consolidated group are now subject to immediate taxation.

\textsuperscript{28} The rules are discussed in more detail in Chapter 7 Section 7.2.

\textsuperscript{29} For clarity purposes, "rollover" in this context includes the similar policy of "neutralisation": see discussion of the policies and their subtle differences in Chapter 7 Section 7.3.
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Under the rollover policy, any gain or loss on intra-group asset transfers is deferred. The deferred gain or loss is in general recaptured when either the transferor or the transferee leaves the consolidated group.

(b) Deemed no transfer:
In Australia, its strong single entity concept dictates that all assets of subsidiaries are deemed to be assets of the parent company during consolidation. It implies that intra-group asset transfers are ignored completely during consolidation.

The “asset-based” model offers a unique tax-friendly environment for corporate groups during consolidation. In contrast to the rollover policy, there is no need to trace movements of assets within a consolidated group, keep records of any deferred gain or loss, or recapture the gain or loss when either the transferor or transferee leaves the group. However, the benefit comes at a high price in terms of the complex and problematic TCS rules.

(c) Immediate taxation:
Though the Italian consolidation regime has a relatively short history since its introduction in 2004, it has already experienced a major policy change for intra-group asset transfers. This is unusual among the eight countries. Italy abolished the rollover-recapture policy in 2008, primarily due to avoidance concerns. The current policy of immediate taxation of intra-group asset transfer deviates fundamentally from the enterprise doctrine. It also violates the policy objective of competitiveness and renders the consolidation regime less attractive.
(iii) Assets at leaving time

Leaving issues arise due to the transition from the enterprise doctrine back to the separate entity doctrine. They are complex as tax attributes of the leaving subsidiary may be a mixture of pre-consolidation tax attributes (for example, gains accrued during the pre-consolidation period) and tax attributes generated during consolidation (for example, gains accrued during consolidation). A leaving subsidiary may take away from the consolidated group assets that have appreciated in value during the period of consolidation. This raises the question of whether the group should be taxed on the unrealised gain. The issue is important as it would affect both the timing of taxation and also the identity of the taxpayer(s) liable to pay tax on the gain.

The policy option at leaving time is primarily dictated by the treatment of intra-group asset transfers during consolidation. The comparative analysis of the eight countries reveals three policy options for this design feature:

(a) Recapture:

If a country adopts the rollover policy for intra-group asset transfers, the deferred gain is in general recaptured when either the transferor or transferee leaves the consolidated group. The option is a logical consequence of the rollover policy for intra-group asset transfer, and also reflects properly the transition from the enterprise doctrine back to the separate entity doctrine.

This is the predominant policy option: all the eight countries except Australia and Italy adopt this option. However, there are some important subtle differences. In three of the six countries (namely, France, Spain and the U.S.), the recapture is triggered if either the transferor or transferee of the previous intra-group asset transfer leaves the consolidated group. In the Netherlands, the recapture is also triggered by
the leaving of either the transferor or transferee, but only if the previous intra-group asset transfer is regarded as tax driven. Recapture is triggered in New Zealand when the transferee leaves the group, while only the departure of the transferor would trigger the recapture in Japan.

Under the enterprise doctrine, gain or loss on asset transfer should be deferred only if the transfer is between group members. It follows that if that relationship ceases to exist and either the transferor or transferee leaves the group, the deferred gain or loss should be recaptured. This is the policy in a majority of the six countries. Other countries may have a different rationale for adopting other policies. For instance, a country may adopt a policy of recapture upon the leaving of the transferor, as the deferred gain or loss should have been taxed in the hands of the transferor without the rollover. Alternatively, a country may recapture the deferred gain or loss upon the leaving of the transferee, so as to avoid the transferee from taking the asset with hidden reserve away from the group tax free.

(b) Inheriting reset cost base:
Under the unique “asset-based” model in Australia, a leaving subsidiary inherits the cost bases of assets – including the reset cost bases created under the tax cost setting rules – which it takes away from the consolidated group. No immediate taxation arises at the leaving time. As discussed above, the major disadvantage of this policy option is that the TCS rules are complex and problematic.

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30 If the transfer is not regarded as tax driven, the assets are rolled over to the leaving subsidiary without immediate tax implications.
(c) No tax implication:

In Italy, as intra-group asset transfers during consolidation are taxed immediately, there is no gain to recapture when a subsidiary leaves the group. As discussed above, the immediate taxation policy removes one of the most significant tax advantages of consolidation regimes, and is contrary to the enterprise doctrine and also the policy objective of competitiveness.

10.2.10 Treatment of intra-group shares

(i) Shares in subsidiaries at joining time

Intra-group shareholdings create a difficult problem that has challenged corporate tax systems for several decades: the dual cost bases issue. The issue arises if the same economic gain or loss is recognised more than once in a corporate group due to the multiple levels of ownership. Most modern corporate tax systems recognise the dual cost bases issue and implement various policies to deal with it. The recognition of the issue implies acceptance of the enterprise doctrine. Under the doctrine, a gain from the disposal of an asset of a subsidiary that has been taxed in the hands of the company should not be taxed again in the hands of its parent company when the latter sells shares in the subsidiary. This is particularly true under consolidation, as the whole group is treated as one single taxpayer.

The comparative analysis reveals three alternative policy options for the treatment of intra-group shares at joining time:

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31 For example, see Hugh J Ault and Brian J Arnold, *Comparative Income Taxation: A Structural Analysis* (3rd ed, 2010, Kluwer, Alphen aan den Rijn), at 358-362. Attempts to deal with the issue in the context of unrealised gain or loss in assets have proved to be particularly complex. For example, see Subdivisions 165-CC and 165-CD ITAA1997 for the Australian rules to deal with multiplication of losses.
(a) Rollover:
Five countries adopt this option, namely France, Italy, Spain, New Zealand and the U.S. All of them adopt the same policy for other non-share assets. The Netherlands is the only country that does not extend the general rollover policy for assets to intra-group shares; instead shares are marked-to-market at joining time, as discussed below.

Under the rollover policy, there are no immediate tax implications for intra-group shares at joining time. The tax attributes of shares in a joining subsidiary are rolled over into the consolidated group.

(b) Mark-to-market:
In Japan and the Netherlands, shares in a joining subsidiary are marked-to-market at the joining time. Any hidden gain or loss in the shares is realised immediately when the subsidiary joins a consolidated group. In effect, the shares are deemed to have been sold to the consolidated group at their market value at the joining time.

The Netherlands adopts this policy as an anti-avoidance measure. It is designed to prevent an otherwise taxable gain on the shares from escaping taxation through consolidation. The deemed sale policy would crystallise taxation on any unrealised gain on shareholdings that do not qualify for participation exemption ("PEX"). Without this policy, an unrealised gain that should not be exempt under the PEX regime would avoid taxation under the consolidation regime.32

The mark-to-market policy violates the realisation principle, reduces the attractiveness of a consolidation regime and contradicts the policy

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32 See discussion in Chapter 8 Section 8.2.
objective of competitiveness. The market valuation at joining time also increases compliance costs.

(c) Deemed to have ceased to exist:
The policy in Australia is very different. Under the asset-based model, shares in subsidiaries held by the parent company are deemed to have ceased to exist upon consolidation.

This policy produces a tax-friendly environment during consolidation: intra-group share transfers are ignored completely. However, serious problems arise for shares in a leaving subsidiary. Reconstituting the cost base of the shares in the leaving subsidiary under the TCS rules has proved to be problematic and complex.

(ii) Intra-group share transfers
None of the eight countries imposes immediate taxation on intra-group share transfers during consolidation. However, this outcome is achieved by different policies:

(a) Participation exemption ("PEX"):
Italy and the Netherlands adopt this policy. Their PEX regimes apply to companies in general, regardless of whether they are members of a consolidated group or not. Intra-group share transfers within a consolidated group in general are eligible for exemption under the PEX regimes, as ownership requirements under consolidation are much stricter than those under the PEX regimes.

The advantages of this policy option are simplicity and neutrality. No additional provisions are required in the consolidation regime to deal
with intra-group share transfers. Furthermore, the PEX regime is applied consistently to both consolidated and unconsolidated corporate groups.

(b) Rollover:
Under this option, any gain or loss on an intra-group share transfer is deferred and rolled over.

France, Japan, Spain and the U.S. adopt this policy option. New Zealand in general does not impose tax on capital gains; intra-group share transfer is therefore most likely a non-issue in New Zealand. However, in some rare cases when shares in a subsidiary are held as revenue assets, their intra-group transfers would be subject to the rollover policy.

(c) Deemed no shares:
As discussed in subsection (i) above, under the asset-based model in Australia, intra-group shares in subsidiaries are deemed to have ceased to exist during consolidation. The fiction dictates that there are no tax implications for intra-group share transfers, as they are deemed not to have occurred. This policy comes at a high price. The TCS rules to reconstruct cost bases of shares in a leaving subsidiary are complex and problematic.

(iii) Intra-group shares at leaving time
Leaving issues arise as the application of enterprise doctrine is transited back to the separate entity doctrine. Tax attributes that have been deferred during consolidation have to be dealt with at leaving time. Intra-group shareholdings present more problems than other assets, as the dual cost bases issue implies that special policies are required to prevent double taxation of profits (or double deduction of losses) of the leaving subsidiary.
For the four countries—namely France, Japan, Spain and the U.S.—that adopt the rollover policy for intra-group share transfers during consolidation, any deferred gain or loss on such transfers is recaptured if either the transferor or the transferee leaves the consolidated group. For the other four countries, this is a non-issue as intra-group share transfers during consolidation are either exempt from tax or deemed to have not occurred.

The policy options for the treatment of shares in the leaving subsidiary are also diverse. This is especially so among the countries that do not have a comprehensive PEX regime for domestic corporate groups. The comparative analysis reveals the following policy options:

(a) Exemption:
All the four EU countries enjoy the benefit of an existing PEX regime. Gain or loss on disposal of shares in a leaving subsidiary is most likely eligible for exemption under the PEX regime. This policy has the advantages of simplicity and neutrality, as explained above in the context of intra-group share transfers.

New Zealand enjoys a similar benefit from the general policy of not taxing capital gains. Disposal of the shares in a leaving subsidiary in most cases does not have any tax implications.

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33 Effective 1 October 2010, the deferral treatment in Japan has been extended to non-consolidated wholly-owned groups of resident companies: see discussion in Chapter 8 Section 8.3.

34 In Japan, the recapture is triggered only if the transferor leaves the group. In France and Spain, the recaptured gain may be exempt from tax under their PEX regimes.
(b) Taxation:

Three countries – namely Australia, Japan, and the U.S. – impose taxation on the disposal of shares in a leaving subsidiary. However, each of them has a different policy to determine the cost bases of the shares:

1. Reconstituted cost base:
   Under the “asset-based” model in Australia, no recapture is necessary for intra-group share transfers as they are deemed never to have occurred. However, problems arise when a subsidiary leaves a consolidated group. At leaving time, the shares in the leaving subsidiary – that are deemed to have “disappeared” during consolidation – spring back to life. They are given back a cost base that is basically reconstituted from the cost bases – including reset cost bases created under the tax cost setting rules – of the underlying assets that the subsidiary takes away from the consolidated group.

The disadvantages of this “asset-based” model are the complex and problematic TCS rules and its failure to solve the dual cost bases issue comprehensively. In particular, double taxation is still possible under the model if a subsidiary leaves a consolidated group taking assets with hidden reserves. Due to the arbitrariness of the TCS rules, artificial gain or loss can be created and even duplicated at leaving time as the cost bases of shares in a leaving subsidiary is reconstituted based on the reset cost bases of assets in the subsidiary. The compliance costs for taxpayers and policing costs for the tax authorities are high, as the TCS rules are not only complex, but also rely heavily on market valuation of assets.
(2) Equity-based model:
In the U.S., the cost bases of intra-group shares are continuously adjusted during consolidation. The primary objective of the adjustments is to avoid double taxation or deduction arising from the dual cost bases issue. This option has proved to be very complex resulting in high compliance and administrative costs in practice. The U.S. had explicitly advised Australia against adopting the equity-based model during the design phase of the latter's consolidation regime.

(3) Adjusted cost base at leaving time:
In Japan, the cost bases of shares in a leaving subsidiary are adjusted at the leaving time, reflecting in general the net change in the retained profits of the company during consolidation.

10.3 A model consolidation regime?
In this section, the eight consolidation regimes are first ranked according to their relative extents of the application of the enterprise doctrine. Their policy options for the ten key structural elements are then summarised in Table 11, which facilitates the search for a model consolidation regime. In the Table, the eight countries are ranked from left to right according to the extent of application of the enterprise doctrine in their consolidation regimes. The ranking is determined by the policy solutions adopted in the countries in respect of the following structural elements:

(1) The single entity concept:
Australia stands out with its bold approach of adopting the strongest version of the enterprise doctrine to date. Its strong single entity concept dictates that subsidiaries are deemed not only to have become divisions of the parent company, but also to have ceased to exist for income tax purposes. Multiple
levels of ownership in a corporate group are collapsed into one. Intra-group shares are also deemed to have vanished during consolidation. The implications are significant. The original cost bases of underlying assets and shares in the subsidiaries are erased and lost forever once they join consolidation.

The Netherlands comes second with its “attribution” concept, under which assets, liabilities and activities of subsidiaries are attributed to the parent company, but the subsidiaries are still regarded as “existing” separate entities during consolidation.

Among the remaining six countries that adopt the pooling system, New Zealand stands out with its general policy of determining taxability and deductibility of various items of each individual group member on a “group” basis. The general application of this group basis represents a relatively stronger application of the enterprise doctrine among the six countries.

(2) The “all in” rule:
Among the remaining five countries, France and Italy allow “cherry-picking” of subsidiaries to join consolidation. This is contrary to the enterprise doctrine under which a corporate group should be treated as one entity. They represent therefore a weaker application of the enterprise doctrine than the other three countries.

(3) Intra-group asset transfer:
Italy significantly violates the enterprise doctrine by imposing immediate taxation on intra-group asset transfers during consolidation. This policy also removes one of the most important advantages of consolidation. Italy is therefore regarded as having the weakest application of the enterprise doctrine among the eight countries.
(4) **Pre-consolidation losses:**

Japan has the unique general policy of cancelling pre-consolidation losses of a joining subsidiary. This policy is not supported by the enterprise doctrine, thus rendering the Japanese consolidation regime a weaker application of the doctrine among the three remaining countries.

Spain and the U.S. adopt the same policy options for most of the key structural elements. The only major difference lies in their treatment of intra-group shareholdings. Spain relies on its general PEX regime while the U.S. applies its unique "equity-based" model under which the cost base of shares in a subsidiary is adjusted continuously during consolidation. This indicates a relatively stronger influence of the separate entity doctrine in the U.S. regime. Spain is therefore ahead of the U.S. in terms of a consistent application of the enterprise doctrine.
Table 11 Key structural elements of consolidation regimes in the eight countries: summary of policy options – Part 1

<table>
<thead>
<tr>
<th>Key Structural Elements</th>
<th>Italy</th>
<th>France</th>
<th>Japan</th>
<th>US</th>
<th>Spain</th>
<th>NZ</th>
<th>Netherlands</th>
<th>Australia</th>
<th>Model regime</th>
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<td>Single entity concept</td>
<td>Pooling</td>
<td>Pooling</td>
<td>Pooling</td>
<td>Pooling</td>
<td>Pooling</td>
<td>Pooling</td>
<td>Attribution</td>
<td>Absorption</td>
<td>Pooling</td>
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<td>Full consolidation of group results</td>
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<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
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<td>Yes</td>
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<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
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<td>Yes</td>
<td>Yes</td>
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<tr>
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<td>No</td>
<td>No</td>
<td>Yes/No</td>
</tr>
</tbody>
</table>

Definition of a group - eligible entities

| - Non-residents | No | No | No | No | No | No | No | No | No | No |
| - P.E. of non-residents | Yes (only as parent entity) | Yes | No | No | Yes (only as parent entity) | No | Yes | No | Indecisive |
| - Top resident parent company | No | Yes | Yes | No | Yes | No | No | Yes | Indecisive |
| - Interposed non-member allowed? | Yes | No | No | No | No | Yes | No | No | No |
| - Brother/ sister companies | No | No | No | No | No | Yes | No | Yes/No | No |
Table 11 Key structural elements of consolidation regimes in the eight countries: summary of policy options – Part 2

<table>
<thead>
<tr>
<th>Key Structural Elements</th>
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<th>Spain</th>
<th>NZ</th>
<th>Netherlands</th>
<th>Australia</th>
<th>Model regime</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Definition of a group - ownership requirements</strong></td>
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<td><strong>Threshold</strong></td>
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<td>≈100%</td>
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<td>Quarantine (offset before aggregation)</td>
<td>Cancel (Note 4)</td>
<td>Quarantine (offset after aggregation)</td>
<td>Quarantine (offset after aggregation)</td>
<td>Quarantine (offset before aggregation)</td>
<td>Transfer</td>
<td>Quarantine (offset before aggregation)</td>
<td></td>
</tr>
<tr>
<td><strong>Group losses</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>During consolidation</strong></td>
<td>Group</td>
<td>Group</td>
<td>Group</td>
<td>Group or subsidiary</td>
<td>Group</td>
<td>Group</td>
<td>Group</td>
<td>Group</td>
<td>Group</td>
</tr>
<tr>
<td><strong>Leaving time</strong></td>
<td>Stay + option to allocate</td>
<td>Stay</td>
<td>Allocate</td>
<td>Allocate</td>
<td>Allocate</td>
<td>Stay</td>
<td>Stay + option to allocate</td>
<td>Stay</td>
<td>Stay</td>
</tr>
<tr>
<td><strong>De-consolidation</strong></td>
<td>Stay</td>
<td>Stay</td>
<td>Allocate</td>
<td>Allocate</td>
<td>Allocate</td>
<td>Stay</td>
<td>Allocate</td>
<td>Stay</td>
<td>Stay</td>
</tr>
</tbody>
</table>

**KEY:**
<< 100% = Substantially less than 100%  
≈100% = Substantially 100%  
S/C = Share capital  
V/R = Voting right

**NOTE:**
1. Plus “profit right”.  
2. Protected by anti-avoidance provision.  
3. Protected by “value” factor in certain circumstances.  
4. Effective 1 October 2010, quarantine if satisfy certain restrictive conditions.
Table 11 Key structural elements of consolidation regimes in the eight countries: summary of policy options – Part 3

<table>
<thead>
<tr>
<th>Key Structural Elements</th>
<th>Italy</th>
<th>France</th>
<th>Japan</th>
<th>US</th>
<th>Spain</th>
<th>NZ</th>
<th>Netherlands</th>
<th>Australia</th>
<th>Model regime</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Assets (except shares)</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>- Joining time</td>
<td>Rollover</td>
<td>Rollover</td>
<td>Mark-to-market</td>
<td>Rollover</td>
<td>Rollover</td>
<td>Rollover</td>
<td>Rollover</td>
<td>Rollover</td>
<td>Reset cost base</td>
</tr>
<tr>
<td>- Intra-group transfer</td>
<td>Immediate taxation (rollover before 2008)</td>
<td>Rollover</td>
<td>Rollover</td>
<td>Rollover</td>
<td>Rollover</td>
<td>n/a (rollover if taxable asset)</td>
<td>Rollover</td>
<td>Deemed no transfer</td>
<td>Rollover</td>
</tr>
<tr>
<td>- Leaving time</td>
<td>n/a (recapture before 2008)</td>
<td>Recapture</td>
<td>Recapture</td>
<td>Recapture</td>
<td>Recapture</td>
<td>n/a (recapture if taxable asset)</td>
<td>Rollover (Note5)</td>
<td>Inherit reset cost base</td>
<td>Recapture</td>
</tr>
<tr>
<td><strong>Intra-group shares</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>- Joining time</td>
<td>Rollover</td>
<td>Rollover</td>
<td>Mark-to-market</td>
<td>Rollover</td>
<td>Rollover</td>
<td>Rollover</td>
<td>Mark-to-market</td>
<td>Deemed ceased to exist</td>
<td>Rollover</td>
</tr>
<tr>
<td>- Intra-group transfer</td>
<td>PEX (Note 6)</td>
<td>Rollover (Note 6)</td>
<td>Rollover (Note 6)</td>
<td>Rollover (Note 6)</td>
<td>Rollover (Note 6)</td>
<td>n/a (Note 7)</td>
<td>PEX</td>
<td>No tax implication</td>
<td>Indecisive</td>
</tr>
<tr>
<td>- Leaving time</td>
<td>PEX</td>
<td>PEX</td>
<td>Taxable: based on adjusted cost base</td>
<td>Taxable: based on adjusted cost base</td>
<td>PEX</td>
<td>n/a (taxable if revenue asset)</td>
<td>PEX</td>
<td>Taxable: based on reconstituted cost base</td>
<td>Indecisive</td>
</tr>
</tbody>
</table>

**NOTE:**
5. Recapture if previous transfer is regarded as tax driven.
6. Deferred gain or loss is recaptured upon transferor or transferee leaving consolidation, except Japan where the recapture is triggered only if the transferor leaves.
7. For shares held as revenue assets, rollover relief for intra-group transfers and deemed sale upon transferee leaving consolidation.

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One of the aims of this comparative study is to identify, as far as possible, from the table a model consolidation regime on optimal policy grounds. The discussion so far suggests that a consolidation regime is often the product of compromises between competing policy objectives and constraints. Nevertheless, it is worthwhile to attempt to identify a model regime representing the best practice in a “clean slate” scenario. The preferred policy options for the key structural elements of a model consolidation regime are shown in the last column in Table 11 above.

With respect to a majority of the key structural elements, the comparative analysis of the eight countries reveals convergence around some of the preferred policies in terms of the tax policy objectives of simplicity, neutrality and competitiveness. A pooling system is preferred to other versions of the single entity concept in terms of simplicity. Interaction between the consolidation regime and other parts of the income tax system is easier as the pooling system preserves to a large extent the separate identity of a subsidiary and thus operates under a similar theoretical framework as the separate entity doctrine. The experience of Australia’s asset-based model demonstrates that a strong single entity concept can be very complex and problematic to operate in practice.

All the eight countries adopt the full consolidation policy for group members’ taxable income and losses, instead of proportional consolidation. The policy is supported by the policy objective of simplicity as well as the enterprise doctrine.

Every consolidated member should be jointly and severally liable for the group’s tax liability. This policy is in accordance with the enterprise doctrine and also enhances revenue collection.
The comparative analysis of the ownership requirements suggests that the ownership threshold should be “substantially 100%”. The presence of minority interests in a consolidated group should be avoided. In respect of the factors in the ownership test, the concept of control in the enterprise doctrine suggests that “voting right” should be a factor in the ownership test. “Shareholding” is simple to apply in practice but prone to abuse. If it is adopted, it should be supplemented and protected by other factors.

In respect of the treatment of pre-consolidation losses of a joining subsidiary, the quarantine policy is not only the most common but also the preferred option on policy grounds. The alternative policies in Australia and Japan are unlikely to be acceptable to other countries. The policy of irreversible transfer of the losses to the parent company in Australia proves to be very problematic. The potential revenue impact is so substantial that the government had to adopt an arbitrary regime to limit the use rate of the transferred losses. The heavy reliance on market valuation of subsidiaries and the consolidated group results in high compliance costs for taxpayers and policing costs for tax authorities. Japan’s general cancellation policy is too harsh and violates the neutrality and competitiveness objectives.

For the policy objective of simplicity, group losses at leaving time should stay with the group, while group losses at de-consolidation should stay with the parent company. These policies are also consistent with the enterprise doctrine.

With respect to the treatment of the assets of a joining subsidiary, the rollover and recapture policy is the most common as well as the preferred option in terms of simplicity and competitiveness. Australia’s asset-based model
provides an unusually tax-friendly environment for corporate groups during consolidation. However, the problems and complexity at the transition times — namely the joining and leaving time of a subsidiary — is a high price to pay. Italy's removal of the rollover policy in 2008 — just four years after the introduction of its consolidation regime — is a vivid illustration of the difficult compromise between competing policy objectives. Its immediate taxation policy on intra-group asset transfers violates fundamentally the enterprise doctrine and is against the policy objective of competitiveness.

The comparative analysis of the other key structural elements fails to reveal a clear preferred policy. The "all in" rule is a classic example of the difficult compromise between competing policy objectives. On the one hand, the rule should be implemented as an anti-avoidance measure. However, on the other hand, some countries believe that an "all in" rule would render their consolidation regime less attractive and adversely affect the competitiveness of their corporate groups. The decision to adopt the "all in" rule or not depends on the relative weight the government puts on each of these policy objectives.

The policy choice on the key structural element of whether an election to consolidate is revocable reflects the same dilemma. The divergent policy options adopted in the eight countries again highlight the difficult balance between the conflicting policy objectives of anti-avoidance and competitiveness.

The policy on intra-group shareholding is perhaps the most difficult structural element to design. The underlying dual cost bases issue has been troubling policy makers for decades. The policy solution depends on whether a comprehensive PEX regime exists for domestic corporate groups in the tax
system. If so, the answer is straightforward. The consolidation regime can benefit substantially by relying on the PEX regime, thus keeping itself relatively simple and immune from the difficult dual cost bases issue. The reliance on the PEX regime also has the advantage of neutrality: both consolidated and unconsolidated groups are treated equally under the regime. New Zealand achieves a similar outcome due to the absence of a general taxation regime on capital gains. However, countries without a comprehensive PEX regime do not have this luxury. They have to incorporate complex rules in the consolidated regimes to deal with the dual cost bases issue. The fact that each of the three countries—Australia, Japan and the U.S.—adopts a different policy on this issue is revealing. One possibility is that they should introduce a comprehensive PEX regime. Nevertheless, the introduction of a PEX regime represents a fundamental corporate tax reform. The experience so far suggests that it is often introduced separately from the consolidation regime which by itself is another fundamental reform of the corporate tax system.

10.4 Conclusion
A common feature of all the eight consolidation regimes is complexity. A consolidation regime is often one of the most complex regimes in an income tax system. Some of the complexity is probably unavoidable, given the inherent conflict between the enterprise doctrine and the traditional separate entity doctrine under which other parts of the tax system are designed to operate. However, the comparative analysis reveals that the eight consolidation regimes represent a spectrum of varying degrees of complexity, depending largely on the policy choices for the key structural elements. The analysis suggests that, though complexity is perhaps unavoidable for a consolidation regime, it is to a large extent manageable.
Chapter 10 Comparative Analysis of Eight Consolidation Regimes

Besides the policy choices for the key structural elements, the presence or absence of an existing regime to deal with the dual cost bases issue is a significant factor affecting the complexity of a consolidation regime. In all the four EU countries, the presence of a general PEX regime for domestic corporate groups significantly relieves the pressure on their consolidation regimes in respect of the dual cost bases issue. New Zealand enjoys a similar benefit due to the absence of a general regime to tax capital gains. As capital gains on disposal of shares in a subsidiary in general are not subject to tax, the dual cost bases issue is often a non-issue in New Zealand. In contrast, Australia and the U.S. have developed highly complex consolidation legislation to deal with the dual cost bases issue.

Given that complexity is unavoidable, the question is whether a consolidation regime is desirable overall. It has been judged to be so in the eight countries. As the policy objective of competitiveness occupies an increasingly dominant role as a driver of tax policies in recent years, it seems inevitable that more countries will introduce a consolidation regime. The comparative analysis is useful to tax policy-makers not only in the eight countries that may consider fine-tuning their regimes, but also in other countries that contemplate the introduction of a consolidation regime.

The comparative analysis suggests that a stronger application of the enterprise doctrine does not necessarily imply a better regime on policy grounds. In contrast, a stronger application tends to introduce complexity and problems into the system. As shown in Table 11 in Section 10.3 above, Australia’s consolidation regime has the strongest application of the enterprise doctrine among the eight countries. Under its world-first “asset-based” model, the single entity rule – driven by the determination to deal with the dual cost bases issue – is the strongest single entity concept applied in a consolidation regime.
to date. Upon consolidation, the rule dictates the fiction that there is only one company left in the consolidated group: the parent company. Subsidiaries are effectively deemed to have ceased to exist for income tax purposes and their assets deemed to be held directly by the parent company.

Australia’s asset-based model offers a couple of distinct attractions that are uncommon in other countries. First, intra-group asset transfers within a consolidated group are ignored completely. There is no need to trace intra-group asset movements, keep records of any deferred gain or loss, or recapture the gain or loss when the transferor and/or transferee leaves the group. Second, as pre-consolidation losses of a joining subsidiary in general are transferred to the parent company, there is no need to compute the subsidiary’s “stand-alone” taxable income every year.

However, the price to pay for these advantages are high, especially at the transition points when a company goes into or gets out of the consolidation regime. The TCS rules are based on flawed theory and can produce outcomes that are detached from reality and defy common sense. Artificial gain can be generated in the process, which can even be duplicated at leaving time. In practice, well-advised taxpayers are more likely to turn this “double trouble” into duplication of losses. The policy of allowing step-up cost bases of assets is arguably too generous, and encourages taxpayers’ creativity. The rules on pre-consolidation losses are based on questionable assumptions and can produce arbitrary and anomalous results. They fail to achieve the government’s stated objective of approximating the loss use rate as if a subsidiary has not joined consolidation.

A strong application of the enterprise doctrine implies that a corporate group is treated as a single entity. Australia’s consolidation regime achieves this
outcome by collapsing multiple levels of ownership into one: the parent company being deemed to own directly all the assets of its subsidiaries. This policy dictates that the consolidation regime has to rely heavily on market valuations of assets and companies, creating avoidance opportunities and resulting in high compliance and policing costs.

Another problem of the strong application of the enterprise doctrine is the difficult interactions between consolidation and other parts of the income tax regimes. Most regimes in the tax law are designed to operate under the separate entity doctrine, which by definition contradicts the enterprise doctrine. The comparative analysis suggests that the stronger the application of the enterprise doctrine is, the more difficult the interactions tend to be.

Despite all these problems, it is unlikely that the Australian regime will be substantially modified. Businesses are busy celebrating the “step-up” cost bases and offset of pre-consolidation losses against group profits. Reversing these policies is therefore politically unacceptable. Nevertheless, it remains doubtful whether the regime – with the problems discussed above – would be an attractive model for other countries.

The comparative analysis sets out to answer another important question of whether a “model” consolidation regime can be identified. For a majority of the key structural elements, the analysis points quite clearly to a predominant policy option in the eight countries. All the eight countries adopt the full consolidation policy in computing the group’s consolidated taxable income or loss. The pooling system is adopted in all of the countries except Australia and the Netherlands. All the eight countries, except France and Italy, impose joint and several liability on group members for the consolidated group’s tax liability. Pre-consolidation losses are quarantined in all of the eight countries.
except Australia and Japan (which also applies the quarantine policy under certain circumstances since 1 October 2010). All the eight countries except Australia and Italy adopt the rollover and recapture policy for assets at the joining and leaving time, as well as for intra-group asset transfers. These predominant policies turn out to be also the preferred policy options in terms of simplicity, neutrality and competitiveness. The comparative analysis suggests that group losses at leaving time and de-consolidation should stay with the group and the parent company respectively, primarily on the ground of simplicity. The ownership threshold should be “substantially 100%” to avoid the “minority interest” problems. In respect of the factors in the ownership test, “voting rights” should be included as a factor constituting “control”. “Shareholding” is simple to apply in practice but should be protected by other factors.

For the other structural elements, the eight countries exhibit considerable variations and reveal no clear preferred policy option. The “all in” rule and revocability of election to consolidate are classic examples of the difficult compromise a government has to make between the competing policy objectives of competitiveness and anti-avoidance. The policies on intra-group shareholdings differ substantially and depend to a large extent on the presence (or absence) of a general PEX regime dealing with the dual cost bases issue. If such a regime is present, the dual cost bases issue is generally a non-issue for consolidated groups. All the four EU countries and New Zealand enjoy this benefit; their consolidation regimes are therefore relatively simpler. The other three countries do not have this luxury. Their policies on intra-group shareholdings are very different but invariably highly complex.

Even if one can identify a model consolidation regime from the comparative analysis, it is important to note a critical qualification. The actual regime
adopted in a country is often the product of difficult compromises between conflicting policy objectives, as well as constraints imposed by existing tax regimes. Local circumstances and constraints should be carefully considered in the design of a consolidation regime. Transplanting foreign policies without due consideration of these issues is dangerous.

Experience suggests that once a consolidation regime is introduced, it is often a road of no return to the government. Businesses enjoy the benefits of intra-group loss offsets and tax free asset transfers under the consolidation regime. Repeal of the regime is therefore most likely politically unacceptable. Once the key structural elements are adopted in the regime, it is difficult to have a major change of policies. Fine-tuning is often the only feasible approach in practice. Therefore, it is important for countries that contemplate the introduction of a consolidation regime to get the legislation right when it is first introduced. The comparative analysis of the consolidation regimes in the eight countries provides a better understanding of the alternative policy options for the key structural elements of a consolidation regime.

This chapter concludes Part Two of this thesis. The next chapter explores and evaluates the possibility of extending the application of the enterprise doctrine to a multilateral level, by drawing substantially from the experience of the CCCTB project in the EU.
PART THREE
MULTILATERAL APPLICATION OF THE ENTERPRISE DOCTRINE

CHAPTER 11
A REALITY CHECK FOR MULTILATERAL CONSOLIDATION: THE CCCTB EXPERIENCE

11.1 Introduction

In Chapter 3, the review of the application of the enterprise doctrine in practice reveals that in practice group taxation regimes are often confined to resident companies in a country. Cross-border application of the doctrine is rare. This chapter explores and evaluates the possibility of extending the application of the enterprise doctrine to a multilateral level.

1 A revised version of this chapter is published as a journal article: Antony Ting, “Multilateral formulary apportionment model - A reality check” (2010) 25(1) Australian Tax Forum 95.
For several decades, the multilateral formulary apportionment ("FA") model has been proposed as the model to replace the existing transfer pricing regime for multinational corporate groups. The most recent and ambitious attempt to apply the enterprise doctrine at a multilateral level is the Common Consolidated Corporate Tax Base ("CCCTB") project currently being considered in the EU. Under the transparent policy on the project, extensive documentation is readily available on the internet. The documents provide valuable information and insights on not only major issues arising from applying the enterprise doctrine on a multilateral basis, but also alternative policies and debates over those issues.

This chapter first provides a brief history of the FA method and reviews the arguments put forward for the multilateral FA model in the past few decades to replace the current transfer pricing regime. Problems of implementing the model in practice are then analysed in light of the detailed information available from the CCCTB project. The analysis suggests that the multilateral FA model fails to demonstrate clear superiority over the existing transfer pricing regime. The CCCTB experience also highlights the formidable political obstacles that hinder the application of the enterprise doctrine at a multilateral level. It is doubtful if the implementation of the model can be justified or is achievable at all.

This chapter does not intend to provide a comprehensive analysis and evaluation of the CCCTB project. Instead, the purpose of this chapter is to assess whether the application of the enterprise doctrine should be or can be

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2 There is extensive literature on this model: see Chapter 2 note 82.

3 The documents for the CCCTB project are available at the EC website: http://ec.europa.eu/taxation_customs/taxation/company_tax/common_tax_base/index_en.htm.
Chapter 11 Multilateral Consolidation: CCCTB Experience

extended to a multilateral level, based on the information available from the project.

11.2 Brief history of the FA method

Though many proposals based on the FA method have been made over several decades, the model has never been implemented as a multilateral regime in practice. In fact, the FA method has not been implemented as a general tax base allocation method on a national level. Back in the 1930s, only a few countries – such as Spain, Switzerland and France – adopted a similar but different method (known as fractional apportionment at that time). Most of them were quite limited in scope.

For instance, though the method was not much used in assessing tax on the profits of an establishment in France, the French authority adopted a fractional method – based on the ratio of a foreign company’s assets in France to its total assets – for dividend and interest payments by foreign companies, which were deemed to be paid out of income arising from a French source. The use of this method was therefore very limited in France. Furthermore, the meaning of “assets” was given the widest interpretation. In practice, the factors actually employed might be real property in the case of an industrial enterprise or turnover in the case of a commercial enterprise, or some combination of these or other factors.

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4 The FA method has been used at sub-national level for many years, for example, in some states in the U.S. and provinces in Canada. However, it has never been adopted at a national level.


6 Ibid, paragraphs 175 & 211.

7 Ibid, paragraph 175.
The fractional apportionment method was used by the 25 Swiss cantons and demi-cantons for enterprises carrying on inter-cantonal or international business, by "apportioning the total net profits in the ratio of the productive elements of the local establishment to those of the whole enterprise".\(^8\) The allocation factors were determined on a case-by-base basis.\(^9\) In other words, the fractional method used in Switzerland was very different from the current proposed FA method, which would use a general mechanical formula for most enterprises.

Spain was the only country that adopted the fractional apportionment method at the federal government level as the general default method of allocating income to a foreign company's establishment in the country.\(^10\) However, the actual method used was different from the currently proposed FA method in a critical way: the allocation formula used then was always "tailor-made" to a particular company/group. In particular, a committee of experts, comprising of "two representatives of banking institutions, the Director-General of Public Revenue, the Director-General of the Stamp and Registration Taxes, the head of the Department of Special Taxes on Companies and an expert of recognised authority", was established to decide on "the economic facts relative to the proportion of the profit realised in Spain, expressed as a percentage of the total income of the enterprise during a [3-year] period".\(^11\)

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\(^{8}\) Ibid, paragraphs 176 & 221.

\(^{9}\) Ibid, paragraph 225. For a brief discussion of the possible allocation factors, see: ibid, paragraphs 226-230.

\(^{10}\) The method was used in Spain for a relative short period of time. It was first adopted in 1920, replacing the separate accounting method. The Spanish government was forced to adopt the fractional apportionment method as "many branches showed little or no profits": ibid, paragraph 184.

\(^{11}\) Ibid, paragraph 195.
The inclusion of financiers and other experts with great experience in the committee was a deliberate attempt of the Spanish government to ensure that the "[allocation] methods employed by the [committee were] exactly analogous to those employed in business practice" (emphasis added).\textsuperscript{12} It was clear that the committee of experts took into account "the particular circumstances of each case ... There is no formula or rule of thumb" (emphasis added).\textsuperscript{13} After making "a first attempt to find the most just formula, [the committee would] call on the representatives of the enterprise ... and ... discuss with these representatives the proposed formula".\textsuperscript{14}

This "tailor-made" approach was also reflected in the fact that many commercial establishments and banks were allowed to use their branch accounting instead of the fractional apportionment method, as their profits could be "approximately determined without resorting to arbitrary [allocation] methods".\textsuperscript{15}

It should become apparent from the above description that the Spanish method was more like the profit-split method under the OECD transfer pricing guidelines than the FA method proposed by various academics. In particular, the latter would apply a general mechanical formula to most enterprises. This contrasts sharply with the "tailor-made" approach adopted in Spain. The FA method as proposed today, therefore, has not been adopted by any country at the national level as the general tax base allocation method.

\textsuperscript{12} Ibid, paragraph 210.
\textsuperscript{13} Ibid, paragraph 202.
\textsuperscript{14} Ibid, paragraph 210.
\textsuperscript{15} Ibid, paragraph 191.
11.3 Arguments for a multilateral FA model

Several reasons have been put forward repeatedly for the multilateral FA model:

(1) Tax avoidance
In general, companies are treated as separate taxpayers under the separate entity doctrine. This is so even if they are members of a corporate group under common control of a parent company. This mismatch between legal form and economic substance provides tax avoidance opportunities, especially for multinational groups. Transfer pricing is a major problem. For instance, income may be shifted to group companies in tax havens. 16

The multilateral FA model is premised on the enterprise doctrine. Intra-group transactions are ignored in the computation of a group's taxable profit or loss, thus removing income-shifting opportunities within the groups. 17 Anti-avoidance is an important motivation for proposing a multilateral FA model. For instance, the European Commission (“EC”) believed that the CCCTB regime with full consolidation of eligible group members would be “the only


17 See for example Avi-Yonah & Clausing, ibid, at 14-16; Li, ibid, at 852; Joann Martens-Weiner, ibid, at 40.
way of overcoming the problems linked to transfer pricing for intra-group transactions” (emphasis added). 18

(2) Simplicity
The current transfer pricing rules are very complex. 19 It is often claimed that corporate tax system will be simpler under the multilateral FA model. 20 Instead of separate tax returns for each group member prepared in accordance with different tax rules in different countries, only one single tax calculation is required for the whole corporate group. Furthermore, a predetermined formula to allocate group profits for all taxpayers would provide greater administrative convenience and certainty for taxpayers. A comprehensive application of the model would also leave little room for traditional international tax planning arrangements, such as transfer pricing, controlled foreign companies, thin capitalisation.

For instance, the EC has suggested that the CCCTB regime would reduce compliance costs and eliminate complexity arising from transfer pricing problems within the bloc. 21

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18 European Commission, “An overview of the main issues that emerged during the discussion on the mechanism for sharing the CCCTB” (CCCTB:WP\052, CCCTB WG, 2007) (“CCCTB WP52”), paragraph 5.


20 See for example Martens-Weiner, ibid, at 40-41; Li, ibid, at 852; McIntyre, ibid, at 918. Some even claimed that there would be "massive increase in simplicity" (emphasis added): Avi-Yonah & Clausing, ibid, at 16.

21 See for example European Commission, “The mechanism for sharing the CCCTB” (CCCTB:WP\047, CCCTB WG, 2006) (“CCCTB WP47”), paragraph 1. The reduction in compliance costs would be expected to result mainly from applying the common CCCTB tax rules to the whole group within EU, instead of applying up to 27 different tax rules of member states.
(3) Neutrality and fairness

The current tax system has systematic bias between branches and subsidiaries. Over-taxation may occur if the system does not allow cross-border loss relief between group companies.

The multilateral FA model is neutral, as it does not bias between branch and subsidiary, and aligns with the economic substance of a corporate group. Furthermore, by agreeing to a uniform apportionment formula, it has been suggested that all participating countries presumably accept that the income allocation under the formula is fair. The CCCTB regime has been argued to deliver "a mechanism to share [the group's tax base] in a fair, efficient and commonly agreed manner among the Member States ... concerned" (emphasis added).

(4) Arbitrariness

The existing transfer pricing methods are applied on a case-by-case, subjective and arbitrary basis, and as a result, very difficult to implement. The underlying assumption of separate entity doctrine contradicts squarely with the

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22 See for example Avi-Yonah & Clausing, above note 16, at 6; Li, above note 16, at 828; McIntyre, above note 16, at 918.
23 See for example Martens-Weiner, above note 16, at 18-20; Li, ibid, at 840.
24 See for example Avi-Yonah & Clausing, above note 16, at 13-14; Li, ibid, at 851; McIntyre, above note 16, at 918 & 923.
25 Peggy B Musgrave, "Sovereignty, entitlement, and cooperation in international taxation" (2001) 26(4) Brooklyn Journal of International Law 1335, at 1344-45. However, this is a chicken and egg issue. A comprehensive international agreement is very difficult to achieve, especially with respect to the sharing of tax revenue. This issue is discussed in more detail below.
26 See for example CCCTB WP47, paragraph 2.
27 See for example Li, above note 16, at 841; McIntyre, above note 16, at 917. It has been argued that the FA model could mitigate the transfer pricing problems within multinational corporate groups: Peggy B Musgrave, "International tax base division and the multinational corporation" (1972) 27 Public Finance 394.
reality that modern international business operations are integrated globally:
"the untangling of profits and their assignment to different source jurisdictions
[under separate entity accounting] becomes an artificial exercise." 28

Each jurisdiction may insist on a transfer price that it thinks reasonable. 29 This
may be so even if the country on the other side of the transaction disagrees
with the transfer pricing. Mismatches between countries are not uncommon
and can result in substantial double taxation. Without international
cooperation, over-taxation can occur. 30

An open and discrete formula under the multilateral FA model to allocate
group profits to different countries would be preferred to the current transfer
pricing regime which often involves arbitrary judgments and negotiations
between multinational corporate groups and tax officials. For instance, the EC
has criticised the current regime as arbitrary in its allocation of a group’s
profits among countries. 31

The above arguments for the multilateral FA model are debatable. These
issues are discussed in more detail in Section 11.5 below. In summary, the
arguments for the model are problematic for the following reasons.

First, the model is not the only possible solution for the transfer pricing
problem. An alternative solution is to improve existing group taxation

28 Peggy B Musgrave, "Combining Fiscal Sovereignty and Coordination: National Taxation in
a Globalizing World" in Inge Kaul and Pedro Conceição (eds), The New Public Finance:

29 Article 9(2) of the OECD model treaty aims to provide relief of the economic double
taxation in these circumstances. However, the effectiveness of this article depends on whether
the competent authorities of the treaty countries can reach an agreement on the transfer prices.

30 Musgrave, above note 25, at 1342-43.

31 For example, CCCTB WP47, paragraph 4.
regimes, including transfer pricing rules, especially the profit-split method which is acceptable to the OECD.

Second, the perceived simplification under the multilateral FA model would be significantly discounted if some major countries refuse to participate. More importantly, the model itself brings enormous complexity to the tax system. Experience of implementing domestic consolidation regimes (for example, in Australia and the U.S.) suggests that applying the enterprise doctrine on a unilateral level is already very complex. Applying the doctrine on a multilateral level is likely to compound the problems. If some countries opt out of the model, the coexistence of the model and the normal tax regimes would create more complexity.

Third, the multilateral FA model would create new opportunities for tax avoidance. For instance, multinational groups may refocus their tax strategies from income-shifting to “factor-shifting”, that is, manipulating the location and valuation of factors used in the allocation formula.

Fourth, the model may also bring unintended consequences that adversely affect fairness and neutrality of a tax system. For instance, it has been suggested that “formulary appointment introduces new distortions to investment and employment decisions ...”.³² The model would likely affect investment decisions of multinational groups as it imposes an “implicit tax” on factors (such as payroll and assets) in the allocation formula.

Fifth, on the issue of arbitrariness, even proponents of the FA model concede that the allocation formula is “inherently arbitrary”.³³

11.4 The CCCTB project

The EC set forth its plan of the CCCTB project in 2001. Since September 2004, the EC and its CCCTB Working Group met basically on a quarterly basis until mid 2008. Over 60 documents, including meeting records and discussion papers have been placed on its website for public access.

The EC believes that by eliminating tax obstacles to cross-border investment within the EU, CCCTB would "contribute to creating a highly attractive area in which to do business in Europe and would help to secure a stable tax base in a competitive world environment". This objective is the major motivation for the EC to promote the CCCTB regime. Its success depends on how much support the Member States ("MS") eventually give to the proposal. Even if the proposed CCCTB regime is actually implemented, a small number of participating MS would significantly reduce its attractiveness.

The CCCTB project proposes a regime that would apply the enterprise doctrine to an unprecedented level. In terms of the key dimensions of the application of the enterprise doctrine to group taxation, the proposed CCCTB regime has the following features:

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34 European Commission, "Towards an Internal Market without tax obstacles: A strategy for providing companies with a consolidated corporate tax base for their EU-wide activities" (COM(2001) 582, 2001).

35 See note 3 above for the website address.

36 European Commission, "CCCTB: possible elements of a technical outline" (CCCTB\WP\057, CCCTB WG, 2007) ("CCCTB WP57"), p.21.

37 For a pessimistic assessment of the number of MS that might participate, see for example Joanna Faith, "EU Common Tax Base in Danger of Unravelling" (2008) June International Tax Review.

38 European Commission, CCCTB WP57. For discussion of the key dimensions, see Chapter 2 Section 2.4.1.
(1) taxable unit: a group of companies resident in the EU ("EU group");
and
(2) tax base: taxable income or loss of the EU group.

The key structural elements of the proposed CCCTB regime are summarised as follows:

(1) the single entity concept: pooling system;\textsuperscript{39}
(2) consolidation of group results: full consolidation;\textsuperscript{40}
(3) liability to tax: each group company shares a portion of the consolidated group’s taxable income and is liable to tax accordingly;\textsuperscript{41}
(4) election to consolidate: the proposed CCCTB regime is optional and the election is for a 5-year term;\textsuperscript{42}
(5) definition of a group: 75 per cent of voting rights;\textsuperscript{43}
(6) the “all in” rule: yes;\textsuperscript{44}
(7) pre-consolidation loss: quarantine;\textsuperscript{45}
(8) group loss: stay with the group at leaving time;\textsuperscript{46}
(9) intra-group asset transfer: at tax written down value;\textsuperscript{47} and

\textsuperscript{39} Ibid, paragraph 86. The consolidation would incorporate 100\% of group members’ taxable income or losses, even if the parent company owns less than 100\% in a subsidiary.
\textsuperscript{40} Ibid.
\textsuperscript{41} Ibid, paragraph 116.
\textsuperscript{42} Ibid, paragraph 11. Once a company elects for the CCCTB regime, consolidation with eligible group companies is mandatory: ibid, paragraph 85.
\textsuperscript{43} Ibid, paragraph 89. In counting indirect holdings, a holding of 75\% or more is counted as 100\% and a holding of 50\% or less is counted as 0\%.
\textsuperscript{44} Ibid, paragraph 85.
\textsuperscript{45} Ibid, paragraph 100. The pre-consolidation loss can be offset against the share of the future consolidated group’s profits attributed to the company.
\textsuperscript{46} Ibid, paragraph 103.
\textsuperscript{47} Ibid, paragraph 106. As the transfer is at tax written down value, there would be no gain or loss on intra-group transfer.
There is no detailed proposal for the allocation formula yet. The absence of this critical element in the CCCTB proposal after several years of consultation suggests that it is very problematic and controversial. Issues of the allocation formula are discussed in the following section.

The project has stalled since August 2008. The postponement of the highly anticipated CCCTB legislative proposal, originally announced in 2007 to be presented “after the summer break in 2008”, was widely regarded as not a good sign. No new deadline for the proposal was announced at that time.

11.5 Problems of a multilateral FA model: the CCCTB experience

This section discusses the major problems of the multilateral FA model, drawing substantially from the experience of the CCCTB project in particular the documents produced by the CCCTB Working Group. To facilitate the discussion of the numerous complicated issues, the analysis is structured around four major categories of problems of the FA method, as depicted below:

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48 Ibid, paragraph 107. Whether there should be recapture rules for unrealised gain on underlying assets in a leaving subsidiary remains an open issue: ibid, paragraphs 107-109.

49 Ibid, paragraph 116.


51 The EC held a workshop on 20 October 2010 discussing a number of issues regarding the CCCTB project, and announced that “a proposal is expected to be brought forward for the first quarter of 2011”; European Commission, “Summary of record by the chair of the Common Consolidated Corporate Tax Base workshop” (CCCTB/20101020 summary), at 4. It is unclear at the time of writing this thesis whether the expected deadline will be met.
The four categories of problems are:

(1) political resistance;
(2) arbitrariness;
(3) complexity; and
(4) tax avoidance.

The problems are often interrelated. An issue (for example, the "no-where sales" issue)\textsuperscript{52} may make the model both arbitrary and complex while at the same time contributes to the political resistance. A comprehensive discussion of all the problems of a multilateral FA model is beyond the scope of this

\textsuperscript{52} For a discussion of the issue, see Section 11.5.2(7) below.
thesis. The following sections discuss some of the major problems highlighted by the CCCTB experience.

11.5.1 Political resistance

Political obstacles have been ignored or put aside, deliberately or otherwise, by many proponents of the FA regime.\(^5\) Even in an economic bloc such as the EU, it is important to understand that "an economic union is not the same as a political union and, for that matter, that a political union is not the same as an economic union".\(^5\)

The issue of weighting given to each of the factors in the allocation formula illustrates vividly the political problems of a multilateral FA method. This is a pure political issue without any "principled basis to decide what weight should be given to a factor".\(^5\) The EC recognises a weighting formula as a solution that "seems to be tailored at balancing the interests of the manufacturing and the marketing states" (emphasis added).\(^5\) The statement highlights that the weighting issue is very political. After studying the overseas experience of the

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\(^5\) For example, the political obstacles were deliberately not addressed at all in an extensive and detailed discussion of the FA method, though they were admitted to be "formidable": McIntyre, above note 16, at 918. Also, the legal framework of a proposed FA regime for North American Free Trade Zone was discussed in detail with the political constraint put aside by simply saying that "there are important political issues of sovereignty": Paul R McDaniel, "Formulary Taxation in the North American Free Trade Zone" (1994) 49 Tax Law Review 691, at 702.

\(^5\) Richard M Bird, "A View from the North" (1994) 49(4) Tax Law Review 745, at 751. It is interesting to note, however, that the EC had reiterated that "the CCCTB would not interfere with MS sovereignty on tax matters ... The creation of a common tax base will not remove fair tax competition among MS, but would probably make tax competition more transparent" (emphasis added): European Commission, "Progress to date and future plans for the CCCTB" (CCCTB/ WP046, CCCTB WG, 2006) ("CCCTB WP46"), paragraph 77. It is doubtful if the EC's claim would be convincing to Member States.


\(^5\) European Commission, CCCTB WP47, paragraph 18.
weighting issue, the EC shied away from the controversy and basically put it into the “political discussion” basket (emphasis added): 57

... the weighting of the factors is not a technical issue and recommend that any discussion on the weighting be carried out at political level and once the impact assessment of the different possible options has been carried out.

Experience in the U.S. demonstrated clearly the fierce competition among its states under their FA regimes. For example, the weighting on the sales factor has been doubled in some states to encourage job growth within those states. 58

It is not difficult to extrapolate that independent jurisdictions would be engaged in similar competition and conflict.

The fact that no country in the world has ever adopted the FA model as the general tax base allocation method at the national level is a strong indication that it is not acceptable to most countries. The political obstacle is formidable because of the following issues:

(1) winners and losers;
(2) removal of traditional tax policy tools; and
(3) administrative issues.


58 It has been observed that “each [US] state has and routinely exercises the power ... to draft and implement its own rules for the taxation of multistate entities and income” (emphasis added): Koin, above note 16, at 199-200.
**Chapter 11 Multilateral Consolidation: CCCTB Experience**

(1) **winners and losers:**

International agreement requires that the procedure promises mutual gains.\(^{59}\) It is difficult to see how “mutual gains” can be achieved under the multilateral FA model. A change from the current international tax system to the model is bound to produce losers in terms of tax revenue.\(^{60}\) International agreement on the formula, for instance, has been argued to be “improbable, given the competing economic interests that are at stake ... The essential problem in adopting formulary apportionment ... is not the concept itself, but the process of working out the details. The negotiation of those details would involve uncertainty about the ultimate revenue effect of the overall formula ...”.\(^{61}\)

The CCCTB experience reinforces the point. The EC is “well aware of the political importance and sensitivity of potential budgetary implications for the MSs”.\(^{62}\) Concerns were raised about the idea of “winners and losers”.\(^{63}\) Empirical researches suggested that some countries (for example, new Member States such as Hungary and Slovak Republic) might gain increased...

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\(^{59}\) Musgrave, above note 28, at 175.

\(^{60}\) William J Wilkins and Kenneth W Gideon, “Memorandum to Congress: You wouldn’t Like Worldwide Formula Apportionment” (1994) 65(10) Tax Notes 1259, at 1262. The FA method may not be a zero-sum game if the worldwide profits of all group members (including those outside the bloc) are incorporated into the tax base for allocation. In particular, profits booked in tax havens would be drawn into the tax base under such a regime. However, in practice, the FA method would most likely be subject to the water’s edge limitation. In other words, only profits of group members in the bloc would form the tax base. Thus the regime is basically a reallocation of the same tax base to participating jurisdictions.

\(^{61}\) Brown, above note 55, at 760. This uncertainty is also true in the EU’s CCCTB proposal. The EC was not certain of the actual allocation implication and therefore suggested that “the whole formula [should be reviewed] after a period of for example, 5 years in order to examine if the apportionment mechanism has lead to an apportionment that can be considered to be fair and equitable distribution of the tax base among the Member States ...”: CCCTB WP60, paragraph 68.

\(^{62}\) CCCTB WP60, paragraph 9.

\(^{63}\) European Commission, “Summary record of the meeting of the common consolidated corporate tax base working group” (CCCTB\WP\059, CCCTB WG, 2007) (“CCCTB WP59”), paragraph 18.
tax revenue while others (for example, Germany and Italy) might have significant reduction in their tax revenues. 64

The EC tried to dismiss the concern by arguing that member states should sacrifice “short-term losses” for “long-term gains” (emphasis added): 65

... a distinction had to be made between the short term ... on the one hand and the long term ... on the other. Even though in the short term situations of ‘winning’ MS and ‘losing’ MS might be revealed, the economic benefits of the new system in the long term would outweigh any potential negative impact for all countries.

This “winners and losers” issue was raised again in the discussion of whether the formula should adjust for the differential wage levels across EU countries. 66 Some “new Member States” argued for such adjustment to “avoid

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64 See for example Michael P Devereux and Simon Loretz, “The Effects of EU Formula Apportionment on Corporate Tax Revenues” (2008) 29(1) Fiscal Studies 1, particularly the table summarising the estimated effects for different countries at 16. One of the reasons given for the shift of tax revenue from Germany to the new member states was the car production sites of two German groups - Audi and Volkswagen - located in Hungary and Slovak Republic respectively: ibid, at 17-18. The presence of major production facilities in a country would imply substantial shares of the labour and asset factors there. This effect also illustrates another problem of the FA model: the tax system becomes less neutral. In other words, tax considerations can become a more important factor in the group’s decision of the location of its production facilities. This distortion caused by a tax system is not desirable, as it would violate the traditional efficiency principle (namely a tax system should not affect as far as possible business decisions of taxpayers).

65 CCCTB WP59, paragraph 19.

66 European Commission, “Report and overview of the main issues that emerged during the discussion on the sharing mechanism” (CCCTB/WP056, CCCTB WG, 2007) (“CCCTB WP56”), paragraph 16. Empirical studies on the proposed CCCTB regime also suggested that the labour factor - covering payroll and/or number of employees - tended to have the most significant effect on the distribution of overall tax revenue among jurisdictions: see for example Devereux & Loretz, above note 64, at 4.
an unfair apportionment". However, some "old Member States" disagreed and argued that, among other things (emphasis added):

... this adjustment would not be justified, because ... there should be a convergence [of the wage levels] *in the medium term* ...

There are two problems with this "long-term" argument. First, the claim that all countries would have net gain from the new FA system in the long term does not seem to be supported by research. Second, even if the claim is correct, it is doubtful if countries are willing to sacrifice in the short term for the "long term" common good.

Many Member States are so concerned about the revenue impact of the CCCTB that they are preparing analysis of the likely impact themselves, even though the EC is conducting an EC-wide "impact assessment" as part of its

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67 This is not surprising as empirical studies tend to confirm that "the differences between the relative shares of the number of employees [among EU countries] and the relative shares of the cost of employees are particularly pronounced for the new member states ...": see for example Devereux & Loretz, ibid, at 10.

68 CCCTB WP56, paragraph 16.

69 It is clear that some countries will not be willing to sacrifice in this way. For example, Ireland prevents any "short term" pain by rejecting the CCCTB proposal outright: Faith, above note 37. Also, member states that supported adjustment to the wage levels argued that "it would take many years for wage levels in the EU to be comparable, whereas the consequences on the tax base distribution would be immediate" (emphasis added): CCCTB WP59, paragraph 9.
work on the proposed regime. Some are also sceptical about the accuracy of the EC impact assessment.

(2) Removal of traditional tax policy tools
Another reason for jurisdictions objecting to the FA method is the removal of traditional tax policy tools. For instance, countries may offer, for national interest, tax incentives to multinational corporate groups, for example preferential corporate tax rate for foreign manufacturing companies, and specific tax incentives for holding companies. It is not surprising that Ireland has been vigorously opposing to the CCCTB proposal from the beginning.

Empirical studies tend to support the position that countries known for offering attractive tax incentives to multinational corporate groups would lose tax base if an FA model is introduced.

(3) Administrative issues
Another area where national interests may collide is the administration system of a multilateral FA model. For instance, if a group’s tax base is allocated to twenty countries under the model, and the group objects to the assessment, the

70 It is interesting to note that the EC seemed to be surprised when it found out that some Member States were working on their own assessment: CCCTB WP59, paragraph 63. Germany is reported to be one of the countries that has commissioned such an assessment, and the result is not encouraging: Faith, ibid. For an example of the empirical studies estimating the impact of CCCTB, see Clemens Fuest, Thomas Hemmelgarn and Fred Ramb, “How would the introduction of an EU-wide formula apportionment affect the distribution and size of the corporate tax base? An analysis based on German multinationals” (2007) 14(5) International Tax and Public Finance 605.

71 For the problems of collecting data from member states, see CCCTB WP59, paragraphs 66-72.

72 For example, see Fuest, above note 70, at 617-618.

73 Faith, above note 37.

74 Fuest, above note 70, at 617.
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question is how the dispute should be resolved. Which country (or countries) should be in charge of the negotiation with the group? If the twenty countries have different opinions, should the dispute be resolved on a majority basis? These issues arise due to the cross-border nature of a multilateral FA model. 75

The CCCTB experience on the administration issues confirms that they are problematic and controversial. The basic administrative structure proposed by the EC is that the ultimate parent company of the group would be the “principal taxpayer” who would file the consolidated tax return to the tax authority of the Member State of residence (“the principal tax authority”). 76

While providing in general support to the idea of “harmonised rules on the administrative framework so as to avoid tax administration shopping”, Member States have raised many questions “relating to the various bodies [for example, central body for issuing interpretation] suggested ... as well as the need to regulate the panels, their functioning, ... and the people who could sit on different bodies” (emphasis added). 77 It is not surprising that, on the issue of joint audit, “many questions were raised as to the relationship between the principal tax authority and the other competent authorities” (emphasis added). 78 The EC provided a diplomatic answer: “a fair balanced relationship

75 A FA system had been proposed for the North American Free Trade Zone and the proponent acknowledged that such a system “would work only if binding decisions could be made [under a mechanism resolving disputes between the countries and the taxpayers] that would prevent any treaty country from adopting domestic rules producing double (or no) taxation ... within the NATFA zone”; McDaniel, above note 53, at 707. McDaniel also acknowledged that such an administrative mechanism would be very complex, as he commented that “[o]bviously, one could write a book solely about the concept of a NATFA Tax Commission ...”: ibid., at 725.

76 CCCTB WP59, paragraph 35.

77 European Commission, “Summary record by the chair of the meeting of the common consolidated corporate tax base working group” (CCCTB\WP\64, CCCTB WG, 2008) (“CCCTB WP64”), paragraphs 28-29.

78 Ibid, paragraph 34. Questions included: (a) what if a national authority wished to launch an enquiry into companies in their territory without agreement or even referring to the principle
has to be established so as to prevent the principal tax authority from deciding everything" (emphasis added).\(^79\) It is unclear if the answer provides any comfort to Member States.\(^80\)

Different penalty regimes at the national level serve as another example of the potential conflicts between jurisdictions. The lack of an EU-wide common penalty regime would encourage "undesirable competition between MS and therefore lead to some kind of penalties shopping" (emphasis added).\(^81\) However, the EC believes that as "the actual source of legislation for penalties in many MS does not necessarily come straight from tax legislation ... arriving at a common approach on [penalties] would be too complicated and therefore not feasible".\(^82\)

\(^79\) CCCTB WP64, paragraph 34.

\(^80\) Some Member States are also concerned about "principal tax authority shopping": see Appendix C Section C.4.3.

\(^81\) CCCTB WP63, paragraph 10. Some Member States are also concerned about "principal tax authority shopping": see Appendix C Section C.4.3.

\(^82\) Ibid, paragraph 10.
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The multilateral FA model is made more political as the formula effectively imposes an “implicit tax” on the factors, and thus can affect the behaviour of multinational groups. For instance, a formula with property and payroll as factors “discourages assets and employment in high-tax locations”.

A look at the history in the EU does not offer an optimistic outlook. Up until the current effort of the EC on CCCTB, “although member states have been working together since 1957, the introduction of a common tax base never seemed to be a realistic option”. The postponement of the CCCTB legislative proposal in August 2008, to someone familiar with the history, should come as no surprise.

Brown provided a good summary of the political difficulties of implementing a multilateral FA system:

Negotiations would be particularly difficult because there is no principled basis for resolving many ... issues, which are simply policy issues affecting the allocation of income among jurisdictions for tax purposes. Given the complexity and the economic interests at stake, it is highly unlikely that consensus could be reached. Arm’s length pricing at least has a unifying principle – the price that would have been charged between unrelated parties – whatever its difficulty in application. The lack of a comparable principle in formulary taxation


86 Brown, above note 55, at 768.
makes the international implementation of such a system practically impossible.

Almost forty years ago, an UN report stated that "even in a federal union, such as the United States, no agreement [on a formula] could be reached between the states. The task of bringing about an agreement ... at an international level would be even more formidable ...". Ten years ago, the OECD rejected the FA method for the following reasons (emphasis added):

The most significant concern with global formulary appointment is the difficulty of implementing the system in a manner that both protects against double taxation and ensures single taxation. To achieve this would require substantial international coordination and consensus on the predetermined formulae to be used and on the composition of the group in questions ... Reaching such agreement would be time-consuming and extremely difficult ... Even if some countries were willing to accept global formulary apportionment there would be disagreements [on] factors in the formula ... Each country would have a strong incentive to devise formulae ... that would maximise that country's own revenue ... The transition to a global formulary apportionment system therefore would present enormous political and administrative complexity and require a level of international cooperation that is unrealistic to expect in the field of international taxation.


The CCCTB experience suggests that the political constraint continues to be a formidable obstacle to a multilateral application of the enterprise doctrine.

11.5.2 Arbitrariness

One of the arguments for the multilateral FA model is that the transfer pricing rules are arbitrary. However, the model itself does not score much better in terms of arbitrariness. Even proponents of the model concede that the formula is "inherently arbitrary". It may allocate profits to a country where profits were not earned. For example, a group may genuinely incur losses in a country while the group overall is profitable. Contrary to economic reality, the formula also assumes "equal productivity and proceeds for all production factors".

A critical issue of the multilateral FA model is the allocation of tax base among jurisdictions. The allocation exercise has been described as difficult as "slicing a shadow". In contrast to transfer pricing rules which produce adjustments that are tailor-made for a particular group, a multilateral FA model makes allocation based on a uniform formula applicable for all eligible

89 Avi-Yonah & Clausing, above note 16, at 22. Li made the same concession, but argued that the model "would be more certain": Li, above note 16, at 844.

90 Some proponents of the model concede that this is indeed possible, but still argue that it is "fallacious ... to conclude that the designers of [the model] have indulged in some counterfactual assumption about the way income is earned within a corporate group": McIntyre, above note 16, at 922. Others attempt to argue that these anomalies "should be eliminated in the long-run as profit maximizing companies relocate their investment until rates of return are equalized across locations" (emphasis added): Martens-Weiner, above note 16, at 42.

91 Schön, above note 83, at 1078.

groups in every participating country. As every group is different, the allocation is bound to be arbitrary.

The major reasons why a multilateral FA model is arbitrary include:

1. different income-generating power of factors across jurisdictions;
2. different income-generating factors for passive and active business income;
3. mechanical generic formula;
4. multiple-business corporate groups;
5. scope of factors: theory vs reality;
6. valuation of factors: theory vs reality; and
7. “no-where sales”: interaction between the two doctrines.

(1) Different income-generating power of factors in different jurisdictions

This problem arises due to differences in the productivity and profitability of each dollar of payroll, asset and sales between jurisdictions. As discussed above in the context of political resistance, the issue was highly controversial when some Member States argued for adjustments in the CCCTB allocation formula to compensate for the different wage levels among jurisdictions.

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93 Coffill & Willson Jr, above note 92, at 1116. See Appendix C Section C.1.1 for more detailed discussion of the issues.
94 CCCTB WP60, paragraph 26.
(2) Different income-generating factors for passive and active business income

The primary objective of the FA method is to allocate tax base of a group to jurisdictions according to the income-generating factors located in each jurisdiction. The traditional 3-factor formula (namely payroll, asset and sales) "was developed primarily for manufacturing and mercantiling companies". It is questionable if such a formula is appropriate to allocate passive income and capital gains, or even business income of service industries. During the CCCTB consultation process, it has been suggested that capital gains on disposal of immovable property should be allocated exclusively to the country where the property is located. However, if different formulae are used for active and passive income, the system would be more complex and subject to disputes. For instance, countries may disagree on classification of particular items of income (for example, substantial capital gain from sale of subsidiary), as the classification would determine which country would collect the tax revenue.

While the EC inclines towards a generic formula for all types of income, some experts believe that "non-business income (mainly passive income such as interest, royalties and dividends) [should] be allocated directly to the [Member State] of source ...". However, the EC is not in favour of it, believing that a generic formula approach "is the simplest one".

95 McDaniel, above note 53, at 710.
96 CCCTB WP47, paragraph 8.
97 This system of multiple allocation methods was suggested by Paul McDaniel for NAFTA region: McDaniel, above note 53, at 720-722.
98 Brown, above note 55, at 763.
99 CCCTB WP60, paragraph 15.
100 CCCTB WP56, paragraph 5. For more discussion of this issue, see Appendix C Section C.1.2.
(3) *Mechanical generic formula*\(^\text{101}\)

A generic formula that is applicable to most cases and acceptable to all parties concerned is a necessary component of a viable FA system.\(^\text{102}\) Unfortunately, such a generic formula is bound to be arbitrary and fail to take into account specific circumstances of each corporate group.

The EC recognises that the “mechanical” nature of the generic formula can be problematic, and proposes a “safeguard clause” to avoid “unfair” results.\(^\text{103}\) Interestingly, the proposal is the result of “strong and unanimous recommendation by the U.S. and Canadian tax administrations”.\(^\text{104}\) Based on actual implementation experience, they are well aware that “it is *practically inevitable* that specific individual cases would arise where the standard allocation formula would lead to results that would be perceived to be ‘unfair’”.\(^\text{105}\)

It is doubtful if the clause would be effective in practice, as its application is intended to be very restrictive. The clause would apply only in “very exceptional cases” and any adjustment “should be commonly agreed by the tax administrations concerned and not be granted ... unilaterally”.\(^\text{106}\) Experience in the U.S. is not encouraging. The safeguard clause is rarely

\(^{101}\) For more detailed discussion of this issue, see Appendix C Section C.1.3.


\(^{103}\) CCCTB WP60, paragraph 71.

\(^{104}\) CCCTB WP59, paragraph 30. Some EU experts “remain rather sceptical” of the need for such clause: CCCTB WP56, paragraph 42.

\(^{105}\) CCCTB WP56, paragraph 42.

\(^{106}\) CCCTB WP60, paragraph 71.
invoked at the request of taxpayers, and even when it is invoked the relief is "granted, if at all, only after litigation is instigated by a taxpayer".  

(4) Multiple-business corporate groups

In the modern commercial world, it is not uncommon for multinationals to have several lines of businesses. If one single formula is used to allocate the group's worldwide profits to jurisdictions, the result is bound to be arbitrary as the income-generating factors for each business line would likely to be different.

One solution proposed by the EC is to apply industry-specific formulae to certain industries, such as "financial services, transportation services such as airlines and railways, and television and broadcasting services". This approach is pragmatic but has two problems. First, it makes the FA regime more complex. Second, and perhaps more importantly, the approach brings back the problems of transfer pricing: the "devil" that the FA method is designed to conquer. To separate a group into different businesses and allocate income and expenses among them would inevitably encounter the familiar transfer pricing issues.

(5) Scope of factors: theory vs reality

In theory, the allocation formula should incorporate all relevant and significant factors to reflect their income-generating power. However, in practice, that is far from the truth.

107 Coffill & Willson Jr, above note 92, at 1110-1111.
108 CCCTB WP60, paragraph 69.
For example, the EC has suggested that “for reasons of practicality and simplicity”, the “asset” factor in the formula should exclude the following items:\(^{109}\)

(i) trading stock;
(ii) financial assets; and
(iii) intangible assets.

The EC argued that despite “a very important component of assets for certain sectors (e.g. trading companies)”, trading stock should be excluded “because inventory could be rather mobile and therefore ... prone to manipulation”.\(^{110}\)

The EC similarly tried to justify the exclusion of financial assets based on anti-avoidance grounds, though that does not seem to be a concern for financial institutions (emphasis added):\(^{111}\)

... due to the mobility and high value of financial assets they could easily be used for factor ... shifting purposes. An exception for financial institutions could be envisaged as financial assets represent the main income generating part of the asset factor for those institutions.

It is not clear why the “main income generating asset” justification is not equally applicable to trading stock for trading companies.

The EC also argued that intangible assets should be excluded because (emphasis added):\(^{112}\)

\(^{109}\) Ibid, paragraph 30.
\(^{110}\) Ibid, paragraph 31.
\(^{111}\) Ibid, paragraph 32.
First, it is sometimes very difficult to value ... Second, even if a solution to their valuation was found, some uncertainties on their location would still remain ... Third, intangible assets are very mobile and could be used as a tax-planning tool ...

It is clear that the proposed exclusion of intangible assets is controversial. The EC acknowledged that “some experts in the [CCCTB Working Group] have voiced their concern that in case intangibles were not taken into account, an important income-generating factor would be disregarded, thus leading to a misattribution of tax base” (emphasis added).113 In summary, the exclusion of the above items from the “asset” factor may be justified on pragmatic grounds. However, their exclusion contradicts the underlying theory of the multilateral FA model, rendering the allocation result arbitrary.

The CCCTB experience suggests that anti-avoidance concerns feature dominantly in the “many long debates” over the factors in the formula, and ironically, “in the end, [the EC] realised that [it] had no better solution ... than do those who work under the transfer pricing” (emphasis added).114

(6) Valuation of factors: theory vs reality
Market value is in general regarded as the theoretically correct valuation method for an FA system.115 However, as “a practical expedient,

112 Ibid, paragraph 33.
113 Ibid, paragraph 34. Intangibles present controversial and difficult issues in the FA method. Some proponents of the method have argued that intangibles should be included only if “some rule is adopted to fix its location at the place where that property is actually used ... without reference to the location of the ownership rights” (emphasis added): McIntyre, above note 16, at 940.
115 McIntyre, above note 16, at 940.
nevertheless, most of the U.S. states use original cost as a *proxy* for value" (emphasis added).\(^{116}\) In contrast, the EC proposed to value assets in terms of “tax written down values” though recognising that market value is “the theoretically correct value”.\(^{117}\) The theoretically correct valuation is rejected due to “the difficulties and compliance costs related to measuring it”.\(^{118}\)

(7) "No-where sales": interaction between the two doctrines

"No-where sales" is an issue arising from the interaction between the enterprise doctrine and the separate entity doctrine and is a good illustration of the arbitrariness of the multilateral FA model. “No-where sales” occurs if the sale is located in a country either (a) participating in the FA regime, but the group does not have a subsidiary or PE in the country; or (b) not participating in the FA regime.

For the first scenario, the issue is whether the country should have taxing right on its share of the tax base. If so, who should be the taxpayer? If not, where should the location of that sale be? Under the enterprise doctrine, the country should still have the taxing right on its share of the group’s tax base as long as the group has sales, payroll or asset factors located there. This is the recommendation of the U.S. experts to the EC.\(^{119}\) However, the EC was reluctant to adopt this recommendation, as it would represent a drastic change

\(^{116}\) Ibid, at 940. McIntyre did not elaborate on the problems of adopting historical cost, which would produce “distortion [which would be] particularly significant ... in inflationary economy”: Brown, above note 55, at 765.

\(^{117}\) CCCTB WP60, paragraph 36. A related issue is whether the tax written down value at the year-end should be used, or an average over a year. The EC is still seeking comments on this issue: ibid, paragraph 38. The year-end value is simpler, but more arbitrary, as it does not reflect the income-generating capacity over the year.

\(^{118}\) Ibid, paragraph 36. For more arguments between the choice of valuation (including historical costs), see for example, CCCTB WP56, paragraph 22.

\(^{119}\) CCCTB WP64, paragraph 53. The main concern of the U.S. experts was that requiring a subsidiary or PE before tax base could be allocated to a country would lead to “the risk for market States of losing a substantial part of the tax base” (emphasis added): ibid.
from the current rules of taxing group profits and would be inconsistent with the OECD principles.\(^\text{120}\)

If it is accepted that the sales would not be located in that country, the question becomes where the location should be. There are basically three possibilities:\(^\text{121}\)

(i) throw-out rule: that sale is ignored in the sales factor;
(ii) throw-back rule: that sale is deemed to be located in the country where the seller is located (i.e. revert back to “sales by origin” basis); or
(iii) spread throw-back rule: that sale is shared by group members according to their payroll and asset factors.

The EC rejected the first two alternatives – which are in use by states in the U.S. in practice – “due to the potentially incoherent results to which those solutions could lead”.\(^\text{122}\)

Detailed discussion of the “no-where sales” issue is beyond the scope of this chapter.\(^\text{123}\) It is sufficient for the present purpose to recognise that each of the three alternative policy options may be appropriate in different situations, depending on the particular circumstances of a group. Applying a generic mechanical rule to deal with all “no-where sales” issue is bound to produce inappropriate and arbitrary results.

\(^{120}\) CCCTB WP60, paragraph 61. The issue is complicated by the problems of determining the location of a sale, which is discussed in more detail below.

\(^{121}\) For an illustrated example of the alternative policy options, see Appendix C Section C.1.8. For discussions of the throw-back and throw-out rules in the U.S. States, see McIntyre, above note 16, at 941-944.

\(^{122}\) CCCTB WP60, paragraph 59.

\(^{123}\) For more discussion of this issue with a numeric example, see Appendix C Section C.1.8.
In summary, the FA method is inherently arbitrary and thus would likely produce unfair allocation of tax base. Anti-avoidance concerns dictate that the actual FA design would deviate from the fundamental principles. For instance, as factors in the allocation formula are open to taxpayer manipulation, their definitions and scopes have to be compromised thus rendering them less effective as income apportionment criteria.\textsuperscript{124} In fact, the EC acknowledged, amid a heated debate on the possibility of adjustments to correct differentials in wage levels across EU countries, that the allocation formula “does not aim at identifying a \textit{hypothetical scientific truth} but at achieving a \enquote{rough (although fair) approximation ...}” (emphasis added).\textsuperscript{125} It is clear that the EC is well aware that the FA method is just a “rough estimate” approach. But it is not clear as to why it believes that such an arbitrary allocation could still be “fair”.\textsuperscript{126}

The OECD prefers transactional profits methods over the FA method, as the former is based on “careful analysis of the particular facts and circumstances [of a specific multinational corporate group] ... thus [avoiding] the globally pre-determined and mechanistic nature of global formulary apportionment methods” (emphasis added).\textsuperscript{127} The OECD has even suggested that “the distortions produced by formulary apportionment are likely to be greater [than

\begin{footnotesize}
\begin{itemize}
\item \textsuperscript{124} Roin, above note 16, at 204.
\item \textsuperscript{125} CCCTB WP56, paragraph 17.
\item \textsuperscript{126} As discussed in the context of “political resistance” above, it is clear that some member states are “calling for some adjustment to take into account the lower average level of wages in those countries and avoid an unfair apportionment” (emphasis added): ibid, paragraph 16.
\end{itemize}
\end{footnotesize}
the present system] ... and so such a system is likely to be less fair” (emphasis added). 128

11.5.3 Complexity
Simplicity has been suggested as one of the reasons for introducing the multilateral FA model. However, the CCCTB experience suggests otherwise. The complexity of the proposed CCCTB regime is ironically highlighted in a taxation paper commissioned by the EC itself. 129 After distributing the paper to Member States as preparation for discussion, the EC had to play down the complexity highlighted in the paper (emphasis added): 130

The ... paper ... focuses mainly on the complexities and challenges linked to the various apportionment mechanism systems and may give the impression to the readers that the sharing out mechanism is very complicated and burdensome. However, it does not include a comparison between the apportionment mechanism and the current system of separate accounting ... with arm's length pricing ... and therefore does not examine the disadvantages of the [current system].

The complexity of the CCCTB regime arises primarily from the following sources:


129 Ana Agundez-Garcia, “The Delineation and Apportionment of an EU Consolidated Tax Base for Multi-Jurisdictional Corporate Income Taxation: A Review of Issues and Options” (European Commission Taxation Paper, 2006, EC, Luxembourg). For instance, in the conclusion of the paper, the author stated that “[the] result seems to be that both the delineation and apportionment of an EU [common tax base] continuously encounters important technical ... difficulties” (emphasis added): ibid, p.85. The complexity of the FA method under the proposed CCCTB contradicts the EC’s basic principle of the sharing mechanism, namely it should be “as simple as possible to apply for taxpayers and tax administrations ...”: CCCTB WP60, paragraph 8.

130 CCCTB WP47, paragraph 3.
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(1) number of taxpayers affected;
(2) definition of a “group”;
(3) definition of “tax base”;
(4) apportionment formula;
(5) transitions and interactions between the two doctrines; and
(6) international issues.

Some of these issues are summarised below.\textsuperscript{131}

11.5.3.1 Number of taxpayers affected
The existing transfer pricing problems affect only group members with cross-border transactions. Companies with no or minimal cross-border transactions would not be substantially affected by the problems. However, under the multilateral FA model, every group member of a multinational enterprise — including those without cross-border transactions — would by default be examined and all their activities would be subject to scrutiny. It has been predicted that “the universe of the transactions that will have to be examined [under the FA method] will increase dramatically. One always must be careful that the cure is not worse than the disease”.\textsuperscript{132}

11.5.3.2 Definition of a “group”
Even proponents of the model concede that it is difficult to define what a group should be under the model.\textsuperscript{133} The task is made more difficult as

\textsuperscript{131} For more detailed discussion of the issues, see Appendix C Section C.2.

\textsuperscript{132} Coffili & Willson Jr, above note 92, at 1116-1117.

\textsuperscript{133} See for example Avi-Yonah & Clausing, above note 16, at 23-24; Li, above note 16, at 844. The issues related to the definition of a group under domestic consolidation regimes are discussed in detail in Chapters 7 and 8.
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multinational groups will “attempt to include or exclude some [entities] from a common enterprise to minimize its taxes”. Issues include.

(1) Sandwich structure:
A “sandwich structure” refers to a group of resident companies with a non-resident intermediary holding company. The issue is whether the non-resident intermediary holding company breaks the ownership chain. The current position of the EC is that such structure does not break the ownership chain. The rationale for the EC position is that “otherwise taxpayers could split groups into multiple groups”, though it does not explain why it is not acceptable for a corporate group to form multiple consolidated groups. The EC position may be explained by the eagerness of the EC to make the CCCTB regime as attractive to businesses as possible. The EC is willing to take this position even though it is aware of the potential “double dip” issues and the possible problems to audit these structures. Specific anti-

134 McIntyre, above note 16, at 935.
135 For discussion of two other issues of the definition of a group, namely “eligible entities to join the CCCTB regime” and “unitary vs multiple businesses”, see Appendix C Section C.2.2.3 respectively.
136 CCCTB WP57, paragraph 87.
137 The policy contrasts with the Australian consolidation regime, under which foreign owned groups (known as MEC groups) may form multiple consolidated groups, even though all companies involved are ultimately owned by the same non-resident parent company: Division 719 ITAA1997. Interestingly, the Australian model is inconsistent in the sense that corporate groups owned by resident parent company do not enjoy this flexibility. In particular, a non-resident intermediary holding company in such domestic groups would break the ownership chain, and resident companies under this non-resident company are not eligible to consolidate with the parent company: s.703-15(2) and 703-45 ITAA1997. This restriction represents a back flip of the original policy (which allowed sandwich structure without breaking the chain), just one year after the introduction of the consolidation regime in Australia. The experience suggests that this issue is complicated and controversial.
138 European Commission, “An overview of the main issues that emerged at the third meeting of the subgroup on group taxation” (CCCTB\WP\053, CCCTB WG, 2007) (“CCCTB WP53”), paragraph 16.
139 For more discussions of the issues, see European Commission, “Anti-abuse rules” (CCCTB\WP\065, CCCTB WG, 2008) (“CCCTB WP65”), paragraphs 40-43. The double dip
avoidance provisions would be required to deal with the issues, thus making the CCCTB regime more complex.\textsuperscript{141} It appears that the EC position is controversial, as a "new round of discussion on this topic did not manage to remove the concerns and reluctance of some experts [from Member States]".\textsuperscript{142}

\textbf{(2) Ownership threshold:}  
One important issue in the definition of a group is the ownership threshold. It is controversial whether the threshold should be set at 50 per cent, 75 per cent, 100 per cent or some other percentage. The issue has been the subject of "intense debate" in the EC.\textsuperscript{143}

The EC proposes a threshold of 75 per cent under the CCCTB regime. It openly admitted that the 75 per cent "was actually a kind of compromise between all thresholds utilised in the EU (between 50\% and 95\% and above 75\% in most [Member States])" (emphasis added).\textsuperscript{144} In essence, the threshold issue involves a trade off between anti-avoidance concerns and

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\textsuperscript{140} European Commission, "An overview of the main issues that emerged at the second meeting of the subgroup on group taxation" (CCCTB\textbackslash WP\textbackslash 048, CCCTB WG, 2006) ("CCCTB WP48"), paragraph 8.

\textsuperscript{141} For alternative anti-avoidance rules targeting the abuses, see ibid, paragraph 42.

\textsuperscript{142} CCCTB WP53, paragraph 16.

\textsuperscript{143} For a description of the "intense debate" about the threshold and the pros and cons of having a threshold lower than 75 per cent, see CCCTB WP64, paragraphs 19-22.

\textsuperscript{144} Ibid, paragraph 19.
attraction of the regime (i.e. as an incentive measure).\textsuperscript{145} Not surprisingly, the position was attacked, as “determining the threshold only by an average is certainly not the base for good policy”.\textsuperscript{146}

11.5.3.3 Definition of “tax base”

Definition of tax base presents another source of complexity.\textsuperscript{147} A key question is whether the tax base of a group should be defined under a new set of rules specifically designed for the multilateral FA model, or should be determined under the tax rules of the country where the parent company resides.

Under the multilateral FA model, a country can get its share of tax revenue in two ways: (1) sharing a group’s common tax base; and (2) imposing other taxes directly on group companies resident in the country.\textsuperscript{148} Conflict of interest arises in the latter scenario: if the other taxes are deductible in the calculation of the common tax base, they would reduce the size of the “pie” for sharing with other countries.

This issue was debated in depth in the CCCTB Working Group.\textsuperscript{149} Solutions suggested include: (1) no deduction for such taxes; or (2) deduction allowed

\textsuperscript{145} The EC believed that a lower threshold (namely 50%), together with the all-in rule, was an effective anti-avoidance policy against “cherry-picking” group entities to join consolidation. However, some member states disagreed and “considered consolidation as an incentive rather than as an anti-abuse measure”, and thus suggested a high threshold (up to 100%): CCCTB WP59, paragraph 36.

\textsuperscript{146} CCCTB WP64, paragraph 19. For more discussion of the ownership threshold issue, see Appendix C Section 2.2.2.

\textsuperscript{147} See for example Schön, above note 83, at 1074-1076; Li, above note 16, at 846; Avi-Yonah & Clausing, above note 16, at 29-31; Martens-Weiner, above note 16, Chapter 5. See Appendix C Section 2.2.3 for a more detailed discussion of the issues with respect to the definition of “tax base”.

\textsuperscript{148} For instance, taxes may be charged on production factors such as payroll or property.

\textsuperscript{149} CCCTB WP46, paragraphs 10 & 11.
only after apportionment of tax base.\footnote{Ibid, paragraph 11.} No specific further discussions on this issue seemed to have taken place, but the current position of the EC appears to be that there is no specific disallowance of such taxes.\footnote{CCCTB WP57, paragraphs 24 & 25.}

Some proponents of the FA method may suggest that the worldwide convergence of IFRS would reduce complexity of the definition of a common tax base. However, IFRS is at best just a starting point. For instance, the EC has stressed that “it is not possible to make a formal link between the [tax] base and ... IFRS”.\footnote{Ibid, paragraph 9.} The reason is that IFRS is not universally adopted in the EU or for all companies.\footnote{For example, many Member States do not permit the use of IFRS for individual company accounts and not all IFRS are considered suitable for tax purposes: ibid, paragraph 9.} This means that under the CCCTB regime, most companies would have to start with accounts prepared under the national accounting rules, and then make necessary adjustments in accordance with the CCCTB rules to arrive at the common tax base.\footnote{Ibid.} However, concerns were raised that the need for 27 different “bridges” between the national accounting rules and the CCCTB rules “would not bring about the simplification ... which it is supposed to”.\footnote{CCCTB WP59, paragraph 20.}

\textbf{11.5.3.4 Apportionment formula}\footnote{For a more detailed discussion of this complex issue, see Appendix C Section C.2.4.}

The design of the apportionment formula is possibly the most difficult issue in a multilateral FA model.\footnote{For a good discussion of the problems, see Schöns, above note 83, at 1078-1079. See also for example Martens-Weiner, above note 16, Chapter 4; McIntyre, above note 16, at 940-941.} It is affected by a matrix of economic, political
and administrative considerations. It involves complex and highly controversial issues, including the number of factors in the formula, choice of factors, definition of each factor, and weighting attached to each factor.

(1) Scope of the formula
It is widely accepted that it is not possible to have only one formula applying to all industries. Experience in the U.S. and Canada suggests that the model would most likely require many industry-specific formulae, thus increasing complexity.

(2) Number of factors in the formula:
A fundamental question is how many factors should be included in the formula. Theoretically, it should include all income generating factors of a corporate group. However, the precision of that approach must be sacrificed for a single common formula.

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158 The OECD recognises a number of issues about the design and implementation of the formula, including exchange rates movements, “intolerable” compliance costs and valuation of factors: OECD, Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (2001, OECD, Paris), paragraphs 3.68-3.71. The issues remain the same at present: OECD, Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (2010, OECD, Paris), paragraphs 1.25-1.32. For a more detailed discussion on the issues, see Martens-Weiner, ibid, Chapter 4. In particular, intangible assets are problematic as they are “highly mobile” and at the same time represent generally significant values and contributions to the overall profitability of the group. It can be difficult to decide whether to include such assets in the formula at all, and if so, how to minimise tax avoidance opportunities. For more discussion on the formula design issue, see James W Wetzler, “Company Tax Reform in the European Union: Guidance from the United States and Canada on Implementing Formulary Apportionment in the EU (Book Review)” (2006) 59(2) National Tax Journal 397, at 399.

159 This is the position of all US experts that participated in one of the EC meetings on CCCTB: CCCTB WP64, paragraph 46. Industries for which specific formulae have been developed include financial institutions, transportation, communications, oil and gas pipelines and professional sports: McDaniel, above note 53, at 710-711.

Proponents of the multilateral FA method have suggested different number of factors in the formula. Some have suggested just one factor.\textsuperscript{161} Many have suggested three factors – payroll, asset and sales – which are the most common factors adopted in existing FA method used in the U.S. States.\textsuperscript{162} Some simply suggested that “[much] more sophisticated factors [than the three factors] need to be developed for today’s multinationals”.\textsuperscript{163}

The current EC position is that it prefers at least three factors.\textsuperscript{164} It believes that a multiple-factor formula would “create a robust, i.e. not volatile apportionment mechanism … [as] the relocation of one unit of one of these factors would shift less than one unit of the tax base” (emphasis added).\textsuperscript{165}

(3) Choice of factors:
The EC has considered three alternative choices of factors – macro-factors (for example, GDP of a country); value added; and traditional micro-factors such as sales and payroll – and finds that all of them are problematic.\textsuperscript{166}

The traditional micro-based approach is the current preferred choice of the EC.\textsuperscript{167} However, the EC’s position is ambiguous, as it states that it intends “to

\textsuperscript{161} For example, some suggested using “sales” as the sole apportionment factor: Avi-Yonah & Clasing, above note 16.

\textsuperscript{162} See for example: McIntyre, above note 16, at 940-941. The EU experts in general accept that payroll and asset are important income-generating factors that should be included in the apportionment formula, but inclusion of the sales factor was much more controversial: for example, see CCCTB WP52, paragraphs 22, 31 & 39.

\textsuperscript{163} McDaniel, above note 53, at 708.

\textsuperscript{164} CCCTB WP60, paragraph 10.

\textsuperscript{165} Ibid, paragraph 10. The other reason given by the EC is that a multiple-factor formula would facilitate negotiation and agreement among countries on the definition and weighting of the factors: ibid.

\textsuperscript{166} CCCTB WP59, paragraph 9-19.

\textsuperscript{167} CCCTB WP60, paragraph 9. For detailed discussions of the three alternatives and the reasons for the EC’s preference, see for example CCCTB WP52.
put the macro-based approach and the [value added approach] in a 'stand by’
position – without definitely excluding these possibilities as a mechanism to
share the consolidated tax base”(emphasis added). In fact, the EC has left
open the possibility of a “hybrid” formula, which combines both macro and
micro factors. For example, “introducing a macro-factor into a micro-based
apportionment could combine the advantage of the fairer sharing attained by
micro-factors ... with some added stability to the mechanism ...”.169
However, a “hybrid” most likely would compound the problems and
complexity of the FA method.

(4) Definition of each factor:
Some of the complexity involved in the definition of each of the allocation
factors (namely, sales, payroll and asset) is summarised below.

Sales factor

The sales factor is perhaps the most controversial among the three typical
factors.170 Issues include:

• Should it be a factor at all?171
The EC supports the inclusion of the sales factor primarily for two reasons.
First, the sales factor is an income-generating factor on the demand side, as
“sales could be seen as a reasonable apportioning factor since companies make
profits only insofar as their output is sold”.172 Second, the EC relies on the
experience in the U.S. and Canada where “sales are currently used in

168 CCCTB WP52, at 11.
169 Ibid, paragraph 48.
170 CCCTB WP56, paragraph 25.
171 CCCTB WP60, paragraph 43.
172 Ibid, paragraph 43. This position was strongly supported by U.S. experts who posed this
challenge: “try to make profits if you cannot sell anything”: CCCTB WP64, paragraph 48.

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formulary apportionment systems of the [two countries] and no plans seem to exist for changing this fact”.

Many experts in the EC disagreed with the “demand side income-generating factor” argument. They argued that sales should not be a factor at all. On one hand, a “sales by origin”\textsuperscript{174} factor would simply duplicate the other two factors, namely payroll and asset.\textsuperscript{175} On the other hand, a “sales by destination” factor in the apportionment formula would be an inconsistent concept to the current international tax regime, under which in general the source country does not have a taxing right on the sales profits unless a taxpayer has a permanent establishment in the country.

• Sales by origin or destination?

If it is accepted that “sales” should be a factor in the allocation formula, a difficult question that follows is whether the location of the sales factor should be at origin or destination. The choice would have very significant implications on the share of tax base by each jurisdiction.

\textsuperscript{173} CCCTB WP60, paragraph 43. In contrast to many EU experts, experts from the U.S. who were invited to advise the EC were clearly in support of the inclusion of the sales factor: CCCTB WP64, paragraph 46. Another reason put forward by the U.S. experts in support of a sales factor is that “it is more difficult for companies to manipulate their markets”: ibid. The emphasis on the sales factor in the U.S. is due to two main reasons: (1) implicit tax on the factors: the factor choice has significant effect on the actual economic activities in a state, which understandably would be reluctant to place more emphasis on the asset and payroll factors; and (2) anti-avoidance concern: it did not take long for the U.S. states to realise that factors of production are more mobile than markets: Roen, above note 16, at 203.

\textsuperscript{174} A “sales by origin” factor implies that tax base would be allocated to the country of origin of the sales. Alternatively, a sales factor may be by destination, meaning that the tax base would be allocated to the source country. Even among supporters of including the sales factor, the two alternatives also caused intense debates in the EC, and will be discussed in more detail below. For the present purpose, it should be noted that the current preference of the EC is the “sales by destination” factor.

\textsuperscript{175} CCCTB WP52, paragraph 39.
Both alternatives have problems and the choice between them is very controversial.\textsuperscript{176} The issue is also political, as sales by destination tends to favour large countries, as “small countries with a limited demand ... would be worse off compared to large countries with a significant internal demand ...”.\textsuperscript{177} Another problem with a “sales by destination” factor is that it is unlikely to be acceptable to “natural resource-exporting” countries. These countries currently have in general the taxing rights over their natural resources,\textsuperscript{178} and it is difficult to contemplate why they would be willing to give up those rights.\textsuperscript{179}

Moreover, both alternatives are subject to manipulation, which is a major concern for the EC.\textsuperscript{180}

- Scope

The EC suggested that passive income (such as dividends, interest and royalties, unless it represents ordinary business income) should be excluded

\textsuperscript{176} For instance, the EC currently prefers sales by destination, but that position clearly is not shared by all: see for example the debate among EC experts on this issue in: ibid, paragraphs 41-43. For the debate primarily between the U.S. and EU experts on this issue, CCCTB WP64, paragraphs 47-58. It appears that in general EU experts were not in favour of sales by destination. For instance, it was reported that “no [EU] expert spoke in favour of sales by destination”: CCCTB WP59, paragraph 13.

\textsuperscript{177} CCCTB WP52, paragraph 43.

\textsuperscript{178} For example, in the EU, it was reported that “at least 90% of the profit [from natural resources] is [taxed] on a source basis”: CCCTB WP64, paragraph 57.

\textsuperscript{179} On this point, it is interesting to observe that the U.S. states which continue to place emphasis on payroll and asset factors “tend to be natural resource rich states, which do not have to worry about business relocations”: Roin, above note 16, at 204.

\textsuperscript{180} For example, sales by origin “could be manipulated ... since group companies could simply choose the place of their establishment [for shipment to their customers] and therefore the origin of sales”: CCCTB WP64, paragraph 58. Sales by destination may be manipulated by routing the sales through an independent distributor in a particular country, while sales by origin may be manipulated by choosing the group company that makes the sales: ibid, paragraphs 50 & 58. See also CCCTB WP52, paragraph 45.
from the sales factor.\textsuperscript{181} Passive income is excluded from the sales factor primarily as an anti-avoidance measure against “factor shifting”.\textsuperscript{182}

In contrast, intra-group sales were suggested to be excluded from the tax base, but to be included in the sales factor.\textsuperscript{183} The EC position may be influenced by political concerns, as “the current tax base distribution within a group composed of, for example, a manufacturing company, a distribution company and a marketing company would be completely changed within a formulary system compared to the current situation" (emphasis added).\textsuperscript{184}

It is unclear if the argument is valid. First, the country in which the manufacturing company is located would receive allocation of tax base under the payroll and asset factors. Second, the inclusion of intra-group sales would create “factor-shifting” opportunities.

- Location
The EC suggested that the location of the sales factor should be determined on the destination basis, that is to the group member located in the country where the sales to third parties occur.\textsuperscript{185} The location rules can be complicated, especially for sales of intangibles. Possible alternative location rules – all of them have been proved to be difficult to apply in practice – include: (a) where the intangible is used; (b) where the intangible is created; and (c) where the

\textsuperscript{181} CCCTB WP60, paragraph 50.
\textsuperscript{182} Ibid, paragraph 51.
\textsuperscript{183} The EC originally appeared to prefer excluding intra-group sales from the factor, but seemed to have changed its mind: CCCTB WP56, paragraph 29.
\textsuperscript{184} CCCTB WP52, paragraph 40.
\textsuperscript{185} CCCTB WP60, paragraph 53. The existing VAT rules on the location where goods and services are deemed to have been supplied were suggested “as a starting point”: Ibid, paragraph 54.
“income producing activities” are performed.\textsuperscript{186} The EC appeared to be silent on this point, unless sales of intangibles are regarded as “extraordinary income” which is specifically excluded from the scope of the sales factor.\textsuperscript{187}

Location of sales is also prone to manipulation. While sales by origin may be manipulated by shifting the sales to third parties from one subsidiary to the other, sales by destination can also be manipulated by assigning a distributor in one country instead of another. Various measures were suggested to counter such manipulations, thus making the regime more complicated.\textsuperscript{188}

\textit{Payroll factor}

Complexity with respect to the payroll factor includes:

- Employee vs self-employed

The payroll factor should theoretically represent the income-generating power of a group's employees. In practice, it is difficult to distinguish between employees and the self-employed. The cross-border nature of CCCTB makes the issue more complex. For instance, countries may have different definitions and interpretation on the meaning of “employee”. The question is which country’s interpretation should prevail.

The current position of the EC is that “all personnel \textit{employed by a given entity} should be covered ... The definition of an employee should be based on domestic legislation of the MS where the employee works and should mutually

\begin{footnotesize}
\textsuperscript{186} Brown, above note 55, at 766; and Wilkins & Gideon, above note 60, at 1264.

\textsuperscript{187} CCCTB WP60, paragraph 50.

\textsuperscript{188} CCCTB WP56, paragraph 34.
\end{footnotesize}
be recognised among MSs..." (emphasis added). The lack of a consistent definition of "employee" among Member States can create complex issues.

The issue also gives rise to avoidance opportunity. The payroll factor may be manipulated by making "use of 'formally' self-employed workers ... who in reality operate as dependent employees ...".

• Outsourced services
It is controversial whether the payroll factor should include outsourced services. Some EU experts argued that they should be included for the following reasons: (1) similar income-generating factor; (2) fairness, and (3) avoidance opportunity. Other experts argued that outsourced services should be included only if they are related to the "core business" of a company. The EC position is to exclude outsourced services from the payroll services, except for outsourcing between consolidated group members.

• Location
Location of the payroll factor is prone to manipulation. For instance, the location of the payroll factor may be shifted to a particular country (for

189 CCCTB WP60, paragraph 22.
190 The EC recognised that "it would be extremely burdensome, and probably impossible ... to harmonise national legislation in order to reach a common definition of an employee": CCCTB WP56, paragraph 8.
191 CCCTB WP52, paragraph 25.
192 CCCTB WP56, paragraph 10.
193 Ibid, paragraph 10.
194 Ibid, paragraph 11. For more discussion on this avoidance opportunity, see Roin, above note 16, at 205.
195 CCCTB WP60, paragraph 24.
example, a low tax country) by: (i) outsourcing of labour,\textsuperscript{196} and (ii) secondment.\textsuperscript{197} In response to the potential factor-shifting, the EC suggested that the location of the payroll factor should be “the place where the employees provide their services”.\textsuperscript{198} This position makes the FA regime more complicated.

\begin{itemize}
  \item Valuation
\end{itemize}

The key valuation issue of the payroll factor is whether the amount of employee remuneration\textsuperscript{199} is sufficient by itself. This begs the question of whether it should be adjusted by say the different levels of wages in different jurisdictions,\textsuperscript{200} and if so, how it should be adjusted.

Some EC experts argued for adjustment “to take into account the lower average level of wages in some MS to avoid an unfair apportionment” (emphasis added).\textsuperscript{201} This issue is political, and not surprisingly, some member states objected to the suggested adjustments. In particular, some argued that as “high wage countries are high price countries, the price of the public services the administration has to provide is higher. Thus a formula including headcount might unfairly reduce their share of the consolidated profit ...” (emphasis added).\textsuperscript{202}

\textsuperscript{196} CCCTB WP52, paragraph 24.
\textsuperscript{197} Ibid, paragraph 26.
\textsuperscript{198} CCCTB WP60, paragraphs 24 & 27.
\textsuperscript{199} The EC suggested that the figure to take into account should be “the amount of remuneration that is taken into account as a deductible expense for the purpose of calculating the tax base, including fringe benefits, social contributions, stock options, etc”: ibid, paragraph 25.
\textsuperscript{200} For arguments for and against such adjustment, see for example CCCTB WP52, paragraphs 28-30; CCCTB WP59, paragraphs 53-54; and CCCTB WP47, paragraph 15.
\textsuperscript{201} CCCTB WP60, paragraph 26.
\textsuperscript{202} CCCTB WP64, paragraph 60.
The EC’s position is somewhat ambiguous. On the one hand, it refused to adopt such an adjustment for the different levels of wages. On the other hand, it suggested inclusion of the “number of employees” – in addition to the amount of remuneration – in the payroll factor and recognised that this inclusion “has to some extent a similar effect”.

**Asset factor**

The asset factor is also very complex. Some of the major issues include:

- **Intangibles**

Intangibles raise significant issues in the asset factor. Theoretically, intangibles should be included in the asset factor, as they are “nowadays one of the potentially most important profit-generating factors”. However, they present serious valuation and location issues. For instance, if intangibles are included in the asset factor, they would “raise exactly the same valuation problems that have been so difficult to deal with in the context of arm’s length pricing” (emphasis added). Furthermore, being very mobile, they are very prone to manipulation.
For these practical reasons, intangibles are typically excluded from the asset factor in the FA regimes of the states in the U.S.\textsuperscript{208} The EC also suggested excluding intangibles from the asset factor due to these reasons.\textsuperscript{209} This is despite the understanding that “an important income-generating factor would be disregarded, thus leading to a *misattribution of tax base*” (emphasis added).\textsuperscript{210}

The EC tried to justify the exclusion by arguing that “intangible assets ... are already (partly) included indirectly in the apportionment formula via ... other factors: salaries of researchers ...; assets used for creating intangibles ...” (emphasis added).\textsuperscript{211} The argument has at least two problems. First, even the EC conceded that even if its argument stands, *part* of the income-generating power of intangibles is still not presented in the formula. Second, it is doubtful if the argument is valid. For instance, an intangible may be created 20 years ago in Country A, but the current research staff and equipment is located in Country B. Using the current payroll and asset factors would produce inappropriate allocation with respect to the intangible.

- Location
The fundamental question of the location of the asset factor is whether it should be located in the country where the owner is, where it is used, or

\textsuperscript{208} McIntyre, above note 16, at 922. The U.S. experts advising the EC also suggested that intangibles should be excluded from the asset factor: CCCTB WP64, paragraphs 63 & 64.

\textsuperscript{209} CCCTB WP60, paragraph 30.

\textsuperscript{210} Ibid, paragraph 34. Some had suggested other factors to capture the income-generating power of intangibles, for example, cost of research and development expenditures: McDaniel, above note 53, at 723. However, those factors did not attract much attention or serious consideration, and thus are not discussed in detail.

\textsuperscript{211} CCCTB WP60, paragraph 34. US experts advising the EC made similar arguments: CCCTB WP64, paragraph 65.
determined by other criteria such as the location of the entity claiming tax depreciation on the asset.

Some EU experts suggested that the asset factor should be located in the country where tax depreciation on the asset is claimed under the CCCTB regime.\textsuperscript{212} This appears to have the initial support of the EC.\textsuperscript{213} However, for factor-shifting concerns, the current EC position is to “attribute the asset to the entity which is effectively using the assets”.\textsuperscript{214} The rule is designed primarily to prevent shifting the asset factor by intra-group leases of assets.

The leased asset issue is complex.\textsuperscript{215} The general location rule of effective use has to be supplemented by a special location rule for leased assets between lessor and lessee belonging to different consolidated groups.\textsuperscript{216} In particular, in such cases, both lessor and lessee would recognise the leased asset in their respective asset factors, but at different valuations.\textsuperscript{217} The EC admitted that “these special rules could introduce some kind of complexities but are borne in the necessity of preventing manipulations ...”.\textsuperscript{218}

\textsuperscript{212} CCCTB WP52, paragraph 36.
\textsuperscript{213} CCCTB WP59, paragraph 10.
\textsuperscript{214} CCCTB WP60, paragraph 39.
\textsuperscript{215} For detail of the EC proposal on the location of leased assets, see Appendix C Section C.2.4.2.4.3(b).
\textsuperscript{216} CCCTB WP60, paragraph 40.
\textsuperscript{217} Valuation issue of leased assets are discussed below. In essence, the economic owner of the asset would value the asset under the normal valuation rule (namely, tax written down value), while the other party would value the asset under a stipulated formula (namely, 8 times the net annual rental): ibid, paragraph 40.
\textsuperscript{218} Ibid, paragraph 65.
• Valuation

It is widely accepted that *in principle* the asset factor should be at market value, which is a better measure of income-generating power of the asset than historical cost or tax written down value. However, while recognising it as the “ideal” approach, the EC rejected market value as it “would create too many complications without providing significant benefits.” Instead, the EC proposed to use “CCCTB tax written down value” as the valuation of the asset factor. The main argument for this option is that tax written down value “reflects most closely the market value of the asset.” It is doubtful if the two figures are always “close” in practice. Furthermore, the tax written down value is problematic. First, tax written down value bears no significant relationship with an asset’s income-generating power. Second, a fully depreciated asset would not be included in the asset factor but may still generate income for the group.

A related issue is whether to take the year-end tax written down value, or the average of the tax written down value for the year. This is basically a dilemma between simplicity and anti-avoidance concern. The year-end option is simple, but prone to manipulation. The avoidance opportunity is

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219 For example, see McIntyre, above note 16, at 940; and CCCTB WP52, paragraph 33. Though having little relevance to the income-generating power of an asset, historical cost is the option adopted by most US states on pragmatic grounds: Wilkins & Gideon, above note 60, at 1264. Designers of the U.S. state FA regime admitted that historical cost was clearly arbitrary, but conceded that no valuation method would be “universally acceptable”: Coffill & Willson Jr, above note 92, at 1107

220 CCCTB WP52, paragraph 33.

221 Ibid, paragraph 33. The EC did not consider historical cost appropriate as “comparability issues may arise due to depreciation at different rates or acquisition at different times”: CCCTB WP47, paragraph 16.

222 CCCTB WP60, paragraph 36.

223 Ibid, paragraph 38.
particularly attractive, as under consolidation intra-group transfer of asset in general is tax free. The EC is still seeking expert advice on this issue.\textsuperscript{224}

(5) Weighting attached to each factor:
The allocation formula has been described as having no “principled basis to decide what weight should be given to a factor”.\textsuperscript{225} The EC also admits that this is a pure policy issue and regards a weighting formula as a solution that “seems to be tailored at balancing the interests of the manufacturing and the marketing states”\textsuperscript{(emphasis added)}.\textsuperscript{226} After reviewing the overseas experience of the weighting issue, it shied away from the controversy and basically put it into the “political discussion” basket.\textsuperscript{227}

In summary, the three factors raise serious problems and complexities when they are actually put into practice. The EC sums up the problems as follows (emphasis added).\textsuperscript{228}

The brief description of the three factors has shown that – in reality – there are no ‘ideal’ solutions and the choice concerning the definition, valuation and location of the factors and their inclusion … in the formula requires a great deal of work.

The challenges arising from the design of the allocation formula is well summarised by Schön (emphasis added).\textsuperscript{229}

\textsuperscript{224} Ibid.
\textsuperscript{225} Brown, above note 55, at 764.
\textsuperscript{226} CCCTB WP47, paragraph 18.
\textsuperscript{227} CCCTB WP60, paragraph 13.
\textsuperscript{228} CCCTB WP47, paragraph 20.
\textsuperscript{229} Schön, above note 83, at 1079.
... only a hybrid formula – such as one consisting in equal parts of wage bill, assets, and sales – should serve the purpose of formula apportionment. With the multiplication of attribution factors, the complexity of the system increases naturally as well as its susceptibility to mistakes and arguments ... ultimately there can only be one decisive criterion for the choice of apportionment factors, that is, the political consensus between [jurisdictions].

11.5.3.5 Transitions and interactions between the two doctrines

The co-existence of two systems – the FA regime under the enterprise doctrine and the traditional tax regime under the separate entity doctrine – is a major source of complexity. The problems arise primarily in two ways:

(i) transitions between the two doctrines, for example, a company entering a consolidated group, or leaving a group; and

(ii) interactions between the two doctrines, for example, interaction of a consolidated group with other entities outside the consolidation regime.

As most of these issues are discussed in detail in the context of domestic consolidation in the preceding chapters, they are not analysed again here. The following paragraphs focus on some examples of the issues arising particularly in a multilateral regime.

(1) Pre-consolidation assets

If a consolidated group disposes of an asset that is owned by a subsidiary before the latter joins the group, the question is who should be the taxpayer for the gain. It appears that this issue falls into the “too hard” basket for the EC,
which does not have a clear position on the issue yet. 230 In particular, the EC simply stated that “transitional rules would be necessary for assets owned by group companies prior to the establishment of the consolidated group”. This issue is particular sensitive for a multilateral FA regime such as the CCCTB proposal, as the taxing right on disposal gains of pre-consolidated assets may be allocated to different countries under alternative policies. 231

The EC’s tentative position is that in general the group should have the taxing right on the whole gain realised on an asset, although some of the gain accrued before consolidation. 232 However, if the joining subsidiary comes from another CCCTB group, the two groups should share the gain by apportionment based on the periods of consolidation in each group. 233 There are two problems with this policy. First, it would be complicated to comply with and administer in practice. Second, it is not clear why the apportionment rule should only apply in the case where the joining subsidiary comes from another consolidated group, but not in the case if a subsidiary by itself joins a group.

(2) Pre-consolidation losses
Most EC experts preferred the quarantine policy on pre-consolidation losses, as those losses were calculated under national tax rules which might be inconsistent with the CCCTB rules. 234 A problematic issue follows. If the pre-consolidation losses are quarantined, the question is whether the subsidiary should be allowed to offset profits before or after apportionment of the group’s tax base.

230 CCCTB WP57, footnote 32 at p.27.
231 See the Appendix C Section C.2.5.1.1 for detailed discussion of the alternative policies.
232 CCCTB WP53, paragraph 45.
233 Ibid, paragraph 46.
234 See for example CCCTB WP48, paragraph 10; CCCTB WP53, paragraph 22; and CCCTB WP57, paragraph 100.
The EC position is to apply pre-consolidation losses after apportionment of the group's tax base.\textsuperscript{235} The main reason for such policy is simplicity, as it avoids calculation of taxable income of the subsidiary under national tax rules (instead of CCCTB rules) after consolidation.\textsuperscript{236}

A potential problem with this policy is that the subsidiary may be allocated less taxable income under the FA model than the amount of taxable income calculated under national tax rules. In that case, the subsidiary may not have enough taxable income to fully utilise the pre-consolidation losses before the carry forward time limit expires (if such time limit exists under national tax law). Some were concerned that this might amount to discrimination against pre-consolidation losses.\textsuperscript{237}

(3) Sale of shares vs assets

On the issue of unrealised gains on assets of a leaving subsidiary, the main concern of the EC is non-taxation. Under the current CCCTB proposal, sale of shares in a subsidiary would be exempt under participation exemption rules.\textsuperscript{238} In that case, the question is whether unrealised gain of underlying assets in the subsidiary should be taxed at the leaving time.

The EC experts are divided on the issue. Some prefer simplicity and argue for a blanket full participation exemption regardless of any underlying unrealised gains in the assets.\textsuperscript{239} The EC is not keen on this option, as it "would ...

\textsuperscript{235} CCCTB WP48, paragraph 10.
\textsuperscript{236} Ibid, paragraph 10.
\textsuperscript{237} CCCTB WP59, paragraphs 40-42.
\textsuperscript{238} It is proposed that gains of disposal of non-portfolio shareholdings by a group to entities both within and outside the bloc would be exempt: CCCTB WP57, paragraph 126.
\textsuperscript{239} CCCTB WP53, paragraph 43.
plainly be open to abuse as assets could easily be transferred into a company and the shares sold”. Other EC experts are more concerned about avoidance opportunities and argue that the sale of shares should be deemed to be sale of the underlying assets. These experts argue that the policy is “consistent with the idea of treating a CCCTB group as if it were a single entity and the sale of an entity should be treated in the same way as the sale of an asset”. The EC also seems to be reluctant to adopt this policy and suggests that “some might consider ... that this [argument of deemed asset sale] pushes the logic too far” (emphasis added).

Having dismissed both suggestions as “extreme”, the EC proposes an “intermediate solution”: participation exemption would not apply to the extent that “assets were transferred to the departing company within the present or previous tax year [without valid commercial reasons] and their disposal would have triggered a gain ...”. Such an anti-avoidance provision would make the regime more complex.

(4) Optional regime
The CCCTB is most likely an optional regime, implying that all existing national tax systems will remain in operation. The introduction of an optional CCCTB regime in the EU increases the number of tax systems

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240 CCCTB WP57, paragraph 109.
241 CCCTB WP53, paragraph 43.
242 Ibid. This “asset model” is adopted in the Australian consolidation regime, and has proved to be very complex and can produce arbitrary results.
243 CCCTB WP57, paragraph 108.
244 CCCTB WP57, paragraphs 108-109. Some experts even suggest that for anti-avoidance purpose the two-year period should be extended, particularly for intangible assets: CCCTB WP59, paragraph 43.
245 CCCTB WP57, paragraph 85.
working within the bloc. The operation of the multilateral FA regime, together with the simultaneous operations of 27 national tax systems, would likely increase rather than decrease complexity of the tax system in the bloc.

11.5.3.6 International issues

The proposed CCCTB regime faces similar challenges as the international tax regime of a country. Compromises often have to be made between anti-avoidance objectives and international competitiveness. For instance, the EC recognises that in the design of the international tax rules of the CCCTB regime, “there is an important balance to be struck ... between ... providing adequate protection for the tax base and ... providing a system that is competitive, workable and not overly complex”.

Complexity arising from international transactions under the CCCTB regime includes the following:

- Foreign tax credit (“FTC”)
- Withholding tax
- Participation exemption
- Conflict with tax treaties
- Concept of “resident”
- Profits of a PE
- Transfer pricing between a group and third parties

246 The situation would be more complicated if some Member States decide not to participate in the CCCTB regime at all, as they “may be afraid to give up too many powers and may be reluctant to confer executive powers on the Commission”: Kiekebeld & Smit, above note 85, at 322.

247 It has been argued that though the main argument for CCCTB is simplification, it is difficult to see how the “proposed arrangement of 27 national systems plus the CCCTB could achieve this”: Christiana HJI Panayi, “The Common Consolidated Corporate Tax Base - Issues for Member States Opting Out and Third Countries” (2008) 48(3) European Taxation 114, at 115.

248 CCCTB WP57, paragraph 131.
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Detailed discussion of the issues is presented in Appendix C Section C.2.7. Some of the issues are summarised below.

(1) FTC
As foreign income would be allocated to jurisdictions under the apportionment formula, the corresponding FTC theoretically should be treated in the same way. The “FTC sharing out” policy is supported by the EC.

One problem arising from such treatment is the FTC limit imposed by each jurisdiction. It appears that the EC has not yet adopted a position on the issue. Instead, it simply stated that a “mechanism would be required for calculating the limit of the credit to be given by each MS”.

(2) Withholding tax
An intriguing issue with respect to the cross-border payment of passive income within a consolidated group is whether withholding tax should be levied. Under the enterprise doctrine, the whole group is treated as one single entity and intra-group transactions are in general ignored. Logically it follows that such payments should not be subject to withholding tax.

However, political reality again conflicts with the enterprise doctrine. Some EU countries appear to insist on exercising the right to levy withholding tax on

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249 This is the position of the EC, even though it recognises that much of foreign income might be exempt: ibid, paragraph 118.
250 Ibid, paragraph 120. Such “FTC sharing out” policy was also suggested by McDaniel in his proposal of a FA system for NAFTA: McDaniel, above note 53, footnote 137.
251 For an illustrated example of the issue, see Appendix C Section C.2.7.1.
252 CCCTB WP57, paragraph 120.
253 For a detailed discussion of the different scenario under which withholding tax may apply under the CCCTB regime, see CCCTB WP49, paragraphs 5-15.
Chapter 11 Multilateral Consolidation: CCCTB Experience

such intra-group payments.\(^{254}\) The EC’s position is that withholding tax levied on such payment should be shared out among jurisdictions “according to an agreed mechanism”.\(^{255}\)

(3) Participation exemption

A common participation exemption regime has been proposed in the CCCTB regime.\(^{256}\) As an anti-avoidance measure, the EC suggests that the participation exemption be subject to a switch over to the credit method where the corporate tax rate in the source country is low.\(^{257}\) The threshold for switch over to credit method is suggested to be a tax rate “of not less than 40 per cent of the average statutory corporate tax rate applicable in MS ...”.\(^{258}\) That means the switchover rate would be 9.6 per cent, which is less than the current Irish rate.\(^{259}\) It appears that political concerns are important considerations in the design of the CCCTB regime.

(4) Conflict with tax treaties

Some of the CCCTB rules may conflict with double tax treaties.\(^{260}\) For example, the ten per cent participation exemption threshold suggested by the EC may conflict with existing tax treaties that provide for a lower threshold.\(^{261}\)

\(^{254}\) Ibid, paragraph 11.
\(^{255}\) Ibid, paragraph 11.

\(^{256}\) CCCTB WP57, paragraphs 119-126. It is suggested that the exemption would apply to “major shareholding”, meaning an interest of at least ten per cent of either capital or voting rights, which has been held for an uninterrupted period of at least 12 months: ibid, paragraph 125. The exemption would apply to both dividends and gains on disposals of the shareholdings: ibid, paragraph 126.

\(^{257}\) Ibid, paragraph 127.

\(^{258}\) CCCTB WP57, paragraph 128. Some EC experts suggested that a fixed rate (for example, 10%) would be preferable in practice to the average method: CCCTB WP64, paragraph 23.

\(^{259}\) Weiner, above note 114, at 16.

\(^{260}\) Conflicts of this kind are inevitable, especially given that “MS currently negotiate details in the individual treaties. Some MS do not even apply the same principles consistently in all their tax treaties ...”: CCCTB WP46, paragraph 18.
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The EC's suggested approach is to "allow MS in certain aspects to derogate temporarily from the [CCCTB] rules adopted in order to respect existing obligations ...". This may be a pragmatic approach to deal with the conflicts. However, such flexibility would contradict the primary objective of CCCTB, namely to provide a harmonised corporate tax environment in the common market.

11.5.4 Tax avoidance
The multilateral FA model fails to score better than the current international tax regime in terms of tax avoidance. For instance, it is likely that "many of the avoidance techniques honed by use under the current tax rules would be just as effective at defeating attempts to tax under [the FA] methods of taxation".

Experience of the CCCTB consultation process confirms this concern. The EC suggested that a "general anti-abuse rule could be established in the CCCTB to allow tax authorities to re-characterise wholly artificial transactions". In addition, it also suggested establishing several anti-abuse provisions, including:

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261 CCCTB WP57, paragraph 139.
262 Ibid, paragraph 139.
263 In an article focusing on evaluating possible gains to be generated through the elimination of avoidance possibilities by replacing the current international tax regime with the FA method, Roin concluded that such a drastic change would be unlikely to be justified: Roin, above note 16, at 174-175.
264 For a discussion of the avoidance potential with respect to the optionality of the CCCTB regime, see Appendix C Section C.3.
265 CCCTB WP65, paragraph 6.
266 Ibid, paragraph 10. For more detailed discussion of each of these rules, see ibid, paragraphs 12-45.
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(a) thin capitalisation rules;
(b) switch over rules from participation exemption to credit method;
(c) CFC rules;
(d) rules to re-characterise sale of shares as sale of assets (as anti-abuse rules to protect the participation exemption regime);
(e) anti-double-dip rules for the sandwich situation; and
(f) rules targeting manipulation of factors.

Several observations can be made. First, the design of anti-abuse rules can be more difficult in a multilateral FA model as many countries are involved and agreements are essential for a common set of rules. For instance, not all EU countries have general anti-avoidance provision ("GAAP"). It is not clear if consensus can be reached to introduce a common GAAP in CCCTB.\textsuperscript{267} Second, the first four specific anti-abuse rules in the list above are not new. Transfer pricing issues would still trouble the CCCTB regime.\textsuperscript{268} The CCCTB regime is not better than the existing regimes in this respect. Third, the last two specific anti-abuse rules are new and specific to the CCCTB regime. From this perspective, the CCCTB regime is worse than the existing regimes, as it introduces new avoidance opportunities, thus requiring more specific anti-abuse regimes.

\textsuperscript{267} It can be equally difficult to reach a consensus on specific anti-abuse rules. For example, achieving a common definition of "related parties" among EU countries "is likely to be challenging": Panayi, above note 247, at 119. For the EC's suggested definition, which is based on a widely-defined concept of "control", see CCCTB WP57, paragraph 78.

\textsuperscript{268} For instance, it would still be possible to shift income to group companies in tax havens from the bloc: McDaniel, above note 53, at 733. Transfer pricing can also be problematic \textit{within a} consolidated group, for example, to split profits between different business lines in the same group if some businesses qualify for special allocation formulae. Furthermore, profits of a PE in the EU - which is included in the consolidated regime - of a non-EU head office would have to be determined under separate entity doctrine, thus inviting transfer pricing issues back into the CCCTB regime: CCCTB WP46, paragraph 29.
For instance, factor-shifting is one of the new avoidance opportunities created under an FA regime. The more mobile a factor is, the easier the factor may be shifted. If “sale by origin” is a factor in the allocation formula, it may be shifted easily within a group, as intra-group transactions are ignored under consolidation.

The coexistence of the dual system – namely the CCCTB regime and the normal national regimes – will lead to “considerable creative potential.” Multinational groups can shift income between the two systems. In general, there would be an incentive to shift income to countries adopting the model, as such income booked in those countries does not affect the allocation under the formula. In other words, countries adopting the model will appear as tax havens from the perspective of opt-out countries.

11.6 Conclusion

The multilateral FA model has been hailed as the solution for the existing transfer pricing regime for several decades. Major problems of transfer pricing, that the model is purported to resolve, can be summarised in the following diagram:

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269 The EC believed that assets are the factor whose location is easiest to manipulate: CCCTB WP65, paragraph 45.

270 The EC suggested a possible anti-abuse rule under which intra-group transfers of assets would be ignored if “they are found to be made only with the intention of influencing the distribution of the [tax] base”: ibid, paragraph 45. Based on experience of similar anti-avoidance rules using the concept of “dominant purpose”, one can expect that in practice the anti-abuse rule would be difficult to implement and uncertain to both taxpayers and tax authorities.

271 Schö n, above note 83, at 1077.

272 Avi-Yonah & Clausing, above note 16, at 26. Avi-Yonah and Clausing argue that this “tax haven” effect will force other countries to adopt the model: ibid.
However, the CCCTB experience confirms many concerns of the opponents to the multilateral FA model. A closer look at the model suggests that it is a similar animal with similar problems as the transfer pricing regime:
The primary driving force behind the CCCTB project is competitiveness and economic growth. However, the experience so far suggests that the multilateral FA model fails to exhibit clear superiority over the existing transfer pricing system in terms of complexity and arbitrariness. It is prone to abuse from not only existing avoidance practices, but also new opportunities created by the model itself. The CCCTB experience also highlights the formidable political obstacles that significantly hinder potential extension of the application of the enterprise doctrine to a multilateral level. It is doubtful if a drastic change from the current transfer pricing regime to the multilateral FA model can be justified or is achievable at all.
Chapter 12 Conclusion

CHAPTER 12
CONCLUSION

12.1 Introduction
This thesis provides the first comprehensive comparative analysis of the consolidation regimes in eight countries, namely, Australia, France, Italy, Japan, the Netherlands, New Zealand, Spain and the United States. The purposes of this thesis are twofold. First, alternative policy options for the key structural elements of a consolidation regime are identified, compared and evaluated. The comparative analysis assesses whether a stronger application of the enterprise doctrine in a consolidation regime necessarily implies a better regime on policy grounds. Second, the comparative analysis intends to search for a model consolidation regime, representing the best practice in respect of the key structural elements of the regime.

This chapter summarises the findings and the significance of the comparative analysis, explains the limitations of the research, and suggests future research areas. For detailed comparative analysis of the key structural elements, readers should refer to the respective chapters in Part Two of this thesis.

12.2. Summary of findings
12.2.1 Alternative policy options for key structural elements
The comparative study analyses the following ten key structural elements of a consolidation regime:
(1) The single entity concept;
(2) Consolidation of group results;
(3) Liability to tax;
(4) Election to consolidate;
(5) The "all in" rule;
(6) Definition of a group;
(7) Treatment of pre-consolidation losses;
(8) Treatment of consolidated group's losses;
(9) Treatment of assets; and
(10) Treatment of intra-group shareholdings.

Only one of these ten key structural elements achieves a consensus among the eight countries: consolidation of group results. All the eight countries have full consolidation of taxable income and losses of group members, instead of proportional consolidation, even if a parent company holds less than 100 per cent interest in a subsidiary.

Five key structural elements exhibit convergence of policy options around the best practice:

(1) **The single entity concept:**
Six countries adopt the pooling system, which is the preferred policy option on simplicity grounds. The policy option implies not only simpler consolidation provisions, but also less complicated interactions between a consolidation regime and other parts of the income tax system.
(2) **Liability to tax:**
Six countries adopt the “joint liability” policy option, which is not only consistent with the enterprise doctrine but also enhances the policy objective of revenue collection.

(3) **Definition of a group:**
All the eight countries in general exclude non-resident companies from their consolidation regimes. In respect of the ownership threshold, five countries adopt the “substantially 100 per cent” policy option. Of the remaining three countries, at least the U.S. – which has an ownership threshold of 80 per cent – finds the presence of substantial minority interests problematic.

(4) **Treatment of pre-consolidation losses:**
Six countries adopt the quarantine policy which is also the preferred policy option on policy grounds, contrasting the alternative policies in Australia and Japan that are inferior primarily in terms of simplicity and competitiveness respectively.

(5) **Treatment of assets:**
Six countries adopt the rollover and recapture policy, which is also the preferred policy solution in terms of the policy objectives of simplicity and competitiveness.

The remaining four key structural elements exhibit divergent policy choices among the eight countries and do not have a clearly preferred option on policy grounds:
(1) **Election to consolidate:**
All the eight consolidation regimes are elective; none of them is mandatory. However, they diverge on whether the election is revocable or not. Three countries (the Netherlands, Spain and New Zealand) allow the election to be revoked, while four countries (France, Italy, Japan and the U.S.) do not. The remaining country Australia fails to have a consistent policy on the issue: the election is irrevocable for domestically-owned consolidated groups, but not so for foreign-owned consolidated groups. The divergent policy choices on this key structural element represent the difficult trade off between the policy objectives of anti-avoidance and competitiveness.

(2) **The “all in” rule:**
Four countries (France, Italy, the Netherlands and New Zealand) allow “cherry-picking” of subsidiaries to join a consolidated group, while three (Japan, Spain and the U.S.) impose the “all in” rule. Again, Australia fails to have a consistent policy between domestically-owned and foreign-owned groups. The divergent policies on this key structural element again reflect the delicate balance between the competing policy objectives of anti-avoidance and competitiveness.

(3) **Treatment of consolidated group’s losses:**
All the eight countries in general apply the enterprise doctrine during consolidation by treating group losses as those of a single company. However, the policies are less convergent on the treatment of group losses at leaving time, reflecting again the difficult balance between conflicting policy objectives. Three countries (Australia, France and New Zealand) adopt the “stay” policy, namely, the group losses stay with the consolidated group without allocation to a leaving subsidiary. In three other countries (Japan, Spain and the U.S.), a portion of the group losses is allocated to a leaving
subsidiary. The allocation rules are often complex. The remaining two
countries (Italy and the Netherlands) have a hybrid policy: while group losses
in general stay with a consolidated group, they also allow the group to elect
for allocation of the group losses to a leaving subsidiary. This hybrid policy
provides more flexibility to corporate groups, thus achieving the policy
objective of competitiveness. However, it increases complexity and is subject
to abuse. The treatment of group losses at de-consolidation time exhibits
similar divergent practice.

(4) Treatment of intra-group shareholdings:
The policies are diverse among the eight countries. With respect to intra-group
share transfers during consolidation, two countries – namely Italy and the
Netherlands – rely on the general exemption regime to exempt any gain or loss
of the transfers. New Zealand achieves similar outcome due to the absence of
a general regime to tax capital gains. Other four countries – namely France,
Japan, Spain and the U.S. – adopt the rollover policy and recapture any
deferred gain or loss when either the transferor or the transferee leaves the
consolidated group. Australia, under its asset-based model, effectively deems
that intra-group share transfer does not occur during consolidation, thus
nullifying the issue.

With respect to the disposal of shares in a leaving subsidiary, four countries
(France, Italy, the Netherlands and Spain) enjoy the benefits of an existing
general participation exemption regime for corporate groups, thus rendering
this key structural element a non-issue. New Zealand again enjoys a similar
benefit due to the absence of a general taxation regime on capital gains. Each
of the remaining three countries (Australia, Japan and the U.S.) however
adopts a different policy option for this key structural element, suggesting that
it is one of the most difficult elements to deal with.
The comparative analysis reveals that many policy choices of a country on the key structural elements often represent a trade off between competing policy objectives of simplicity, competitiveness and anti-avoidance. The study shows that the eight consolidation regimes represent a spectrum of varying degrees of complexity, depending primarily on the alternative policy options for the key structural elements in them. For instance, New Zealand's consolidation regime is relatively simple while achieving effectively most of the objectives of a consolidation regime. The analysis suggests that, though complexity is perhaps unavoidable for a consolidation regime, it is to a large extent manageable.

The comparative study also aims to answer the policy question of whether a stronger application of the enterprise doctrine necessarily implies a better consolidation regime on policy grounds. This study suggests that the answer is no. A stronger application of the doctrine tends to introduce complexity and problems into the system. Australia's world-first "asset-based" model represents the strongest application of the enterprise doctrine among the eight countries. It offers a tax-friendly environment for corporate groups once they enter the consolidation regime. However, the price to pay for these advantages is high, especially at the transition points when a company goes into or gets out of the consolidation regime. It is one of the most complex regimes among the eight countries. Another problem of the strong application of the enterprise doctrine is the difficult interaction between consolidation and other parts of the income tax regimes. The comparative analysis suggests that the stronger the application of the enterprise doctrine is, the more difficult the interactions tend to be.
12.2.2 Search for a model consolidation regime

This comparative analysis intends to search for a model consolidation regime. As discussed in the previous section, this study points quite clearly to a predominant policy option in the eight countries in respect of six key structural elements which turn out to be also the preferred policy options on policy grounds. The six structural elements are the single entity concept, liability to tax, consolidation of group results, definition of a group, treatment of pre-consolidation losses and treatment of assets.

For the remaining four structural elements, namely election to consolidate, the "all in" rule, treatment of consolidated group's losses and treatment of intra-group shares, the eight countries exhibit considerable variations and reveal no clear preferred policy option. The divergent policies typically represent a trade off between competing policy objectives of simplicity, competitiveness and anti-avoidance.

Even if one can identify a model consolidation regime from this comparative analysis, it is important to note a critical qualification. The actual regime adopted in a country is often the product of not only difficult compromises between conflicting policy objectives, but also constraints imposed by existing tax regimes. Local circumstances and constraints should be carefully considered in the design of a consolidation regime. Transplanting foreign policies without due consideration of these issues is dangerous.

Experience suggests that once a consolidation regime is introduced, it is often a road of no return to the government. Businesses enjoy the benefits of intra-group loss offsets and tax free asset transfers under the regime. Repeal of the regime is therefore most likely politically unacceptable. Furthermore, once the structural elements are adopted in the regime, it is difficult to have a major
change of policies. Fine-tuning is often the only feasible approach in practice. Therefore, it is important for countries that contemplate the introduction of a consolidation regime to get the legislation right when it is first introduced. The comparative analysis of the eight countries provides a better understanding of the application of the enterprise doctrine in practice and the alternative policy options available for tax policy makers with respect to the key structural elements.

12.3 Limitations

This comparative study focuses on the key structural elements of a consolidation regime. Detailed discussion of each consolidation regime - which is often one of the most complex regimes in a tax system - is beyond the scope of this thesis. This study does not, and is not designed to, cover all detailed technical provisions of the eight consolidation regimes.

This study is also limited with respect to the availability of research materials in English. For countries where English is not the official language, the research of their consolidation regimes is confined to the materials available in English. Therefore, this study has relied partly on English translations of the relevant legislation. It is recognised that there may be significant risk of doing so. The risk is minimised as far as possible by double and counter checking of the translation against all other available resources, including databases and commentaries published by professional publishers, books and journal articles written on the consolidation regimes, reports prepared by international bodies on those regimes and tax experts in the respective countries.

Another limitation imposed by the availability of material in English is that the analysis is constantly tempted to be more detailed for the countries with English as their official language. The fact that the author is based in
Australia tends to compound this problem for the analysis of Australia’s consolidation regime. The thesis has been written alert to this potential problem, and has strived to provide as far as possible a balanced comparative analysis among the eight countries.

12.4 Future research areas

This thesis focuses on consolidation regimes that represent one form of application of the enterprise doctrine to the taxation of corporate groups. The doctrine may be, and has been, applied in other forms of group taxation regimes. For future research, one possibility is to extend the consolidation concept to a multilateral level. Though the experience of the CCCTB project so far suggests that such a regime may not be promising, the increasingly dominant presence of multinational groups warrants continuous research in this area.

Another possible area worthy of further research is the application of the enterprise doctrine in the form of a general participation exemption regime for corporate groups. While it is common in the EU, the regime is rare in non-EU countries. This thesis has highlighted the problems of the dual cost base issues in respect of the key structural element of “intra-group shareholdings”, and the relative ease with which the EU countries have dealt with the issue. It may be interesting to explore the possibility of introducing a general participation exemption regime in countries outside the EU.
12.5 Conclusion

This thesis provides the first comprehensive comparative analysis of the consolidation regimes in eight countries, which by the end of the 2009, are the countries that have introduced a consolidation regime in their tax systems. The comparison and evaluation of the alternative policy solutions for the key structural elements advances knowledge and improves understanding of the application of the enterprise doctrine in consolidation regimes in practice. The findings of this study should be useful in assisting tax policy makers to design a new consolidation regime, as well as to refine existing consolidation regimes.
APPENDIX A
THE TAX COST SETTING RULES IN AUSTRALIA

This Appendix provides a summary of the main provisions of the tax cost setting ("TCS") rules in Australia and analyses their problems with respect to the following issues:

(1) the TCS rules at joining time;
(2) the TCS rules at leaving time; and
(3) the TCS rules for multiple-entry consolidated ("MEC") groups.

A.1 The TCS rules at joining time
A.1.1 Basic operation
Diagram 29 summarises the steps required at joining time under the TCS rules:¹

Diagram 29 The tax cost setting rules at joining time in Australia

Figure 1: Cost setting process on formation and entry

A. Calculate joining entity's ACA (allocable cost amount)
B. Subtract value of retained cost base assets (e.g. A$ cash)
C. Apportion remainder of ACA over reset cost base assets in proportion to their market values, subject to adjustment for revenue-like assets
D. Adjust the amounts allocated to depreciable assets
E. Adjust the amounts allocated for certain revenue-like assets

Market valuation

Calculating the entry ACA
1. Start with cost of membership interests
2. Add liabilities
3. Add undistributed frankable profits accrued to the group
3A. Adjust for certain pre-joining time rollovers from a foreign-resident company to an Australian-resident company
4. Subtract distributions of profits not accruing to the group, and those accruing to the group that recouped losses
5. Subtract unused losses accrued to the group, except those reducing step 3 profits
6. Subtract an amount equal to transferred losses that did not accrue to the group, multiplied by the general company tax rate
7. Subtract certain inherited deductions to avoid duplication of benefit
8. The ACA is the remaining amount (if positive) or nil (if negative)

A.1.2 Problems of the TCS rules at joining time

(I) Flawed theory, or no theory at all?

Theoretically, the acquisition cost of shares in a company should represent the net value of assets and liabilities in the company. The relationship may be presented in the following formula:

Share acquisition cost = Value of assets – Value of liabilities
Logically, it is possible — in theory at least — to allocate the share purchase cost to each individual asset, as the above formula can be rearranged as follows:

\[
\text{Value of assets} = \text{Share acquisition cost} + \text{Value of liabilities}
\]

However, the formula is true only at the time of share acquisition, but is no longer true once values of assets and liabilities change over time.

In many cases, shares in a subsidiary are acquired at a different time from the joining time. For instance, a parent company may have acquired all shares in a company in Year 1 and then forms a consolidated group in Year 10. Alternatively, the parent company may have acquired shares in a subsidiary in separate parcels at different times before the subsidiary joins the consolidated group. Similar problems apply to liabilities. Some accounting liabilities are measured at fair value, while others at amortised costs. Mixing items with different valuation times renders the TCS theory flawed.²

This “apples and oranges” problem has another dimension: the TCS calculation mixes tax and accounting items. While the cost bases of shares are determined under the tax rules, liabilities are identified and measured according to the accounting rules. For instance, deferred tax liabilities — an accounting concept that has no meaning in tax law — are included in the TCS calculation and effectively pushed down into the cost bases of assets. It is

² Some of the adjustments in the TCS calculation (for example, adjustments for certain pre-consolidation profits and losses in a joining subsidiary in Steps 3 to 5 of the ACA calculation) may alleviate some of the problems. However, the anomalous resulting reset cost bases — as is illustrated below in the “$74 land” example — suggest that the adjustments are not sufficient to deal with the problems.
Appendix A Tax Cost Setting Rules in Australia

doubtful if the amount – which is not a legal liability – should be included in the TCS-calculation at all.3

The question is what we get by adding together tax items with accounting items and what the resulting “reset” cost base of an asset represents. It is difficult to find a satisfactory answer. Accounting liabilities include not only loans borrowed by a company to acquire assets, but also other items that have little, if any, relationship with the asset cost. For example, accounting liabilities include “provision for employee benefits” whose value may depend on the fair value of options over the company’s shares. Accounting liabilities for a supermarket chain may also include “provision for self-insured risks” which represents the estimated liability for workers’ compensation and public liability claims based on actuarial valuations. It is puzzling why these items – which basically are estimates required under the accounting standards for financial reporting purposes – should be included in the ACA and pushed down into the reset cost bases of assets in the company.4

The fact that a parent company may have a capital gain or loss in the TCS process is evidence of the flawed theory.5 It is difficult to comprehend why at


4 What happens if the provision is different from the realised amount? It would be a nightmare if the TCS calculation has to be redone every time a provision is realised. The solution in Australia was to treat the difference as a capital gain or loss of the parent company: CGT event L7 under section 104-530 ITAA1997. However, there were many problems associated with the treatment and the government has repealed the provision in 2010. This means that over- or under-provisions in financial statements will become a permanent component in the reset cost bases under the TCS regime.

5 For example, a parent company may have a capital loss if some of the allocable cost amount can not be allocated to any asset: CGT Events L4 & L8 in sections 104-515 & 104-35
the joining time the parent company can have a capital gain or loss without any transfer of assets. Even under the SER, assets are just deemed to be those of the parent, without any deemed transfer of the assets. The only reason for the capital gain or loss is that it is artificially manufactured by the TCS rules.

Perhaps the better view is that the search for a theory behind the TCS rules is bound to be futile. Perhaps the TCS regime has no theory at all. It may be simply a mechanism designed to push down and store share acquisition cost in the underlying assets, waiting for it to be pushed back up to reconstruct the cost bases of shares when the subsidiary leaves consolidation. However, a regime without theory runs a high risk of producing arbitrary and anomalous results.

Detailed discussion of the highly technical and complex TCS calculations is beyond the scope of this thesis. Nevertheless, its problems become obvious if one looks at its end product: the "reset cost base" of an asset. The Australian Taxation Office ("ATO") Consolidation Reference Manual – which is prepared to assist taxpayers to understand how the consolidation regime works – ironically provides a telling example illustrating the problems of the TCS rules. In that example, when the parent company A acquired 40 per cent of a subsidiary G on 1 July 2001, G had a piece of land with both cost base and

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6 It is clear that the SER does not deem a transfer of assets from a joining subsidiary to the parent company: Note to section 701-35(3) ITAA1997. The government failed to provide any policy explanation for the CGT events at all: EM to New Business Tax System (Consolidation and Other Measures) Act 2003, paragraphs 5.127-5.131, & EM to Taxation Laws Amendment Act (No.8) 2003, paragraphs 2.19-2.23.

7 One may get this impression after reading the consultation document regarding the policy objective of "determining the cost base for disposal of equity": Review of Business Taxation, A Platform for Consultation (1999), Chapter 27.

market value equal to $100. On 1 July 2002, A acquired the remaining 60 per cent in G and elected to consolidate. At that time, both the cost base and market value of the land remain $100.

After 16 pages of TCS calculations, the “reset” tax cost of the land is $74. The implication is that if the consolidated group sells the land for its market value of $100 (which is the same as its original cost base), the group would have a capital gain of $26. This “step-down” result defies common sense and logic. 10

This result is difficult to comprehend, given that both the “real” cost base and market value of the land have always remained $100 ever since A acquires shares in G. The intriguing question is why the group should have a capital gain of $26, when it sells the land for its original cost.

Combing through the complicated 16-page TCS calculations reveals the causes for this puzzling outcome:

(i) Appreciated assets in the group:
The subsidiary has other assets that have appreciated in value since 1 July 2001. As allocation is based on market values of assets at the joining time, more ACA is allocated to those assets than to the land (which has not appreciated in value).

(ii) New asset recognised at joining time (that is, 1 July 2002):

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9 It is beyond the scope of this thesis to explain the detailed technical calculations that results in this number. Nevertheless, the two main reasons for this puzzling outcome are discussed below.

10 What the ATO does not discuss in the example is that in practice, given the creativity of taxpayers, one would expect a step-up basis – instead of step-down – to be more likely.
Before the joining time, the parent company never recognises any goodwill in its investment in the subsidiary. However, at joining time, goodwill is recognised in the TCS calculation. As a result, part of the acquisition cost for the 40% shares on 1 July 2001 is allocated to the goodwill that was not recognised at that time.

In practice, the creativity of taxpayers and their advisors is likely to produce a reset cost base that is stepped-up instead of stepped-down. The TCS regime thus provides ample tax planning opportunities for corporate groups.

The "reset" cost bases will stay with the asset even if the subsidiary subsequently leaves consolidation. This is one of the implications of the "exit history rule". The anomalous effect of this policy is again well illustrated by the "$74 land" example. The $74 will remain as the cost base of the land if the subsidiary leaves the group. This is so even though the market value of the land has always been $100 and the land has always been owned by the subsidiary throughout the consolidation cycle. In other words, the original "real" cost of the asset is lost forever once it passes through the consolidation process.11

11 The reset cost bases of assets also have significant implications for the cost base of shares in the subsidiary: see the discussion in the following Section A.2 and Chapter 8 Section 8.4.
(2) Complexity

The TCS rules are very complex and occupy over 100 pages of legislation. The law requires that the cost bases of most assets in a group have to be reset on an asset by asset basis. Compliance costs are high. This is not helped by the requirement that a joining subsidiary has to prepare a "notional" balance sheet at the joining time (unless the joining time coincides with an accounting reporting date) in order to identify and measure accounting liabilities as at that day.

In practice, especially for large corporate groups, identification of all assets (especially intangibles) can be an art instead of science. The meaning of "assets" and "liabilities" is also controversial. Valuation of assets and liabilities is problematic. For example, it raises the question of how goodwill should be identified and valued, especially if it is internally generated.

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12 Divisions 705 and 713 ITAA1997. As discussed above, when a subsidiary joins a consolidated group, first it has to go through an 8-step process to arrive at the "allocable cost amount", which will be allocated to each individual asset of the company: Section 705-60 ITAA1997. This is just the first part of a 4-part process to complete the tax cost setting process. The whole process is repeated for every level of shareholdings in the consolidated group, until all costs of shareholdings are allocated to individual assets. The TCS calculations are so complex that the tax law stipulates that certain errors in the calculation would be taken to be correct if, among other things, they are worked out "in purported compliance" with the TCS rules: section 705-315 ITAA1997. In that case, the mistake will result in a capital gain or loss for the parent company. Detailed discussion of these technical rules is beyond the scope of this thesis.

13 Section 701-10(2) ITAA1997.

14 Section 705-70 ITAA1997.

15 The ATO has issued several tax rulings explaining its positions on the meanings of "asset" and "liability": TR2004/13, TR2004/14 and TR2006/6. For an interesting illustration of the problems in relation to "liabilities" and the resulting "notorious provision" in the ACA rules (section 705-80 ITAA1997), see the "accrued $100 million liability for poisoned pies sold by a pie shop" example in Lehmann, above note 3, at 279.

16 The ATO has issued tax ruling TR2005/17 explaining its position on the issues.
Furthermore, the cost base resetting is based on the market values of assets in the subsidiary, thus requiring a major valuation exercise in many cases. Not surprisingly, some taxpayers encounter significant difficulties trying to comply with the rules in practice.  

The administrative and policing costs of the ATO are also very high. The ATO recognises the practical difficulties of complying with the rules, and has to allow some pragmatic “short cuts”.

(3) Avoidance opportunities

The complex TCS regime provides ample tax avoidance opportunities. Planning opportunities can arise from valuation of assets, different depreciation rates among assets, and the meaning of “assets” (especially identification of intangibles) and “liabilities”. The adoption of accounting

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17 For instance, some corporate groups have many thousands of assets, while others may operate different fixed asset systems (e.g. due to acquisitions). These problems are recognised a Practice Statement of the ATO: ATO, “PS LA 2004/12 Consolidation - General short cuts for resetting the tax cost under Division 705 of the Income Tax Assessment Act 1997 for depreciating assets for which the decline in value is worked out under Division 40 of that Act” (2004), paragraph 3.

18 In addition to the inherent problems associated with valuation of assets, the policing cost is particularly high as the tax cost setting rule can result in “step-up” basis of assets: ATO, PS LA 2004/12, paragraphs 7 & 10.

19 Both the ATO and the government recognise the problem. The ATO offers some short-cuts to reduce compliance costs of valuation: ATO, PS LA 2004/12. The government provided certain transitional measures to reduce compliance costs. In broad terms, groups that consolidated before 1 July 2004 could choose to keep the tax values of assets for certain subsidiaries, instead of calculating the “reset” cost bases under TCS regime: Division 701 Income Tax (Transitional Provisions) Act 1997. The transitional rules were optional. Furthermore, the parent company could choose which subsidiaries use the “stick” method on a company by company basis. In other words, groups consolidated in the transitional period could cherry pick the best options.

20 Valuation is particularly difficult and inherently subjective for intangibles, such as goodwill. Taxpayers in general would prefer a lower valuation of goodwill in the context of tax cost setting exercise, as goodwill is not eligible for depreciation in Australia.

21 For example, the meaning of “liability” in the context of the tax cost setting rules was the key issue in Envestra Ltd vs Commissioner of Taxation [2008] FCA 249.
liabilities in the TCS calculation provides further scope for manipulation, as accounting standards may allow a choice between alternative accounting policies.\(^{22}\) Furthermore, the implant of accounting liabilities into tax costs is prone to abuse as the “notional” balance sheet prepared for the joining time is not required to be audited, and the accounting concept of “materiality” implies more flexibility than would normally be acceptable for tax purposes.\(^{23}\)

Market valuation is critical in the TCS regime, as the ACA is allocated to assets generally according to their market values. The higher the market value is assigned to an asset, the higher its reset cost base will be. Ingenuity of taxpayers and their advisors is further encouraged by the fact that the TCS rules allow “step up” basis of an asset. For instance, it would be beneficial to allocate more ACA to depreciating assets than to goodwill which is not eligible for depreciation in Australia. Given that tax depreciation is a significant tax deduction item of many corporate groups, it is understandable that the ATO is particularly alert in policing market valuations adopted in the TCS exercise.\(^{24}\)

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22 The ATO recognises the problem and tries to limit the scope for manipulation: TR2006/6 paragraphs 9 & 20. The ATO’s position was tested and confirmed in Envestra Ltd v FCT [2008] FCA 249.

23 Again, the ATO tries to limit the exposure, though it is not certain how effective it is: TR2006/6 paragraphs 13 & 14.

24 The ATO has prepared detailed market valuation guidelines explaining how it will administer the market valuation provisions in the consolidation regime: Part 4 of the Consolidation Reference Manual. In particular, it has developed the “Advanced Market Valuation Agreements” process. The AMVA concept is similar to transfer pricing Advanced Pricing Agreements and is designed to reduce uncertainties around the derivation and use of market values in consolidation. A proforma of an AMVA can be found in Part C4-1-110 of the Consolidation Reference Manual.
The ATO has issued a 45-page document discussing the application of the general anti-avoidance provision to elections to consolidate. One of the examples illustrates a situation under which the ATO would apply the provision to deny additional depreciation generated under the TCS rules by a consolidated group.

A.2 The TCS rules at leaving time

A.2.1 Basic operation

The cost bases of shares in a leaving subsidiary is reconstructed basically by adding the cost bases — including reset cost bases — of assets taken by the subsidiary, less its liabilities. The TCS steps for leaving subsidiaries can be depicted as follows:

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26 Ibid, Example 2 at page 9.

27 For a detailed technical discussion of the issues of the TCS rules at leaving time, see Tony Stolarek, "Leaving a consolidated group - Separation without tears" (2007) 11(2) Tax Specialist 110.

28 Section 711-5(3) ITAA1997.

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Diagram 30 The tax cost setting rules at leaving time in Australia

A.2.2 Problems of the TCS regime at leaving time

(I) Real cost of asset lost forever

As discussed in Section A.1.2 above, the TCS regime represents a “road of no return” for the original cost bases of many assets in a subsidiary. The “real” cost bases are lost forever and replaced by “reset” cost bases.

Step 1 of the “exit ACA” calculation stipulates that the reconstituted cost base of shares is primarily based on the cost bases of assets – including reset cost bases determined at joining time – that the subsidiary takes away from the
Appendix A Tax Cost Setting Rules in Australia

consolidated group. The "$74 land" example discussed in Section A.1.2 above illustrates vividly that the permanent replacement of the real cost base by the reset cost base is problematic.

(2) "Double troubles"
The "$74 land" example again illustrates the issue well. If the parent company sells all shares in the subsidiary holding the land to a third party and the price reflects the market value of the land ($100), the group would realise a gain of $26 attributable to the land. When the subsidiary subsequently sells the land, the same gain of $26 would be taxable again in the hands of the company. This duplication of gain is created due to the TCS regime.30 By going through the consolidation cycle, artificial gain not only can be created, but also duplicated.31

(3) Complexity
The TCS process at leaving time is complex. If multiple levels of subsidiaries leave a consolidated group, the TCS calculation has to be performed for each level on a "bottom-up" basis.32 The implant of accounting liabilities in the calculation introduces additional complexity and adjustments.33

30 In contrast, if the subsidiary does not join the consolidated group, the cost base of the land would remain to be $100. Thus no gain would be recognised when it is sold for its market value $100.
31 The TCS regime is not the only cause for double taxation in consolidation. Capital gain might be subject to double tax under certain circumstances. For example double taxation would occur if the disposal contract is concluded during consolidation and the title transfer occurs after the subsidiary involved leaves the group. This was known as the "CGT straddles" issue. The ATO's bandaid solution was to allow taxpayers to ignore one of the gains: TD2008/29. In 2008, the government announced that it would introduce legislations to fix the problem. The tax law was finally amended in 2010, basically to override the general timing rules in the CGT regime in order to avoid the double taxation outcome: section 716-860 ITAA1997.
33 Many adjustments are required on the accounting liabilities at the leaving time: section 711-45 ITAA1997. The government has suggested amendments to reduce compliance costs in this
If the leaving subsidiary has more than one class of shares, or option/right over shares, the ACA is allocated to the different classes of membership interests according to their respective market values. Similar to the issues at joining time, the valuation requirement increases compliance costs of taxpayers, policing costs of the tax authority, and creates avoidance opportunities.

\(4\) Failure to eliminate dual cost bases issue

The primary objective of the asset-based model is to eliminate the dual cost bases issue by the "deemed disappearance" of intra-group shareholdings within a consolidated group. The objective is achieved for intra-group asset transfers and also for disposal of assets to a third party outside the group. However, it is not achieved if a subsidiary leaves the group with the asset. This is because any hidden reserve in the asset would be recognised twice: first in the gain on disposal of the shares in the subsidiary, and again when the subsidiary sells the asset. This means that the model fails to eliminate the dual cost bases issue comprehensively.

Consider the following example in Diagram 31 below:


34 Section 711-15(1)(b) & (2) ITAA1997.

35 In contrast, a participation exemption regime that applies to both consolidated and non-consolidated groups would be more effective and comprehensive to deal with the issue.
If Companies A and B (together with other subsidiaries) elect to consolidate, the cost base of the asset would be reset to $100 (i.e. the cost of shares in B). If B is sold to a third party outside the group for $1,000, the group makes a gain of $900. If B then sells the asset for its market value, it will also realise a gain of $900, thus duplicating the same gain that has already been taxed in the hands of the consolidated group.

36 This is of course a simplified example. In practice, the market value of the share price depends on many other factors determining the price of the shares in B. Detailed discussion of the factors and the dual cost bases issue is beyond the scope of this thesis. For a detailed discussion of the issues and a summary of the corresponding policies in different countries, see Richard Vann, “General Report” in International Fiscal Association, Cahiers de Droit Fiscal International Volume 88a: Trends in company shareholder taxation: single or double taxation? (2003).
In summary, the TCS rules fail to eliminate the dual cost bases issue comprehensively. In contrast, a participation exemption regime is applicable to both consolidated and non-consolidated groups, and is more effective and comprehensive to deal with the issue.

A.3 The TCS rules for MEC groups

A.3.1 Basic operation

The consolidation regime in Australia has an unusual feature: it allows consolidation for foreign-owned groups that have multiple entry points in the country. The definition of a MEC group is discussed in Chapter 5 Section 5.2.

The logic of the TCS rules — which is argued to be flawed in Section A.1.2 above — is even more stretched with MEC groups. The question is whether the acquisition costs of shares in the ETls should be pushed down to their assets when the MEC group is formed. One may argue that it should be, as the ETls are in fact subsidiaries and not the parent company. The logic of the TCS rules would suggest that acquisition costs of shares in the ETls should be pushed down to their assets.

In contrast, the government decided that each ETl would be deemed to be part of the head company for TCS purposes. The implication is that cost bases of their assets would not be reset. The rationale, as argued by the government in the context of a joining ETl to an existing MEC group, is that the policy "ensures neutrality between electing... the eligible tier-1 company [joining] a

37 The same issue applies to the case of a new ETl joining an existing MEC group.
38 Section 719-160(2) ITAA1997.
39 Section 719-160(2) ITAA1997, Note 2.
MEC group and electing ... the company [becoming] the head company of a consolidated group” (emphasis added).\(^{40}\)

The MEC rules are in general more flexible and less disciplined than those for domestically-consolidated groups. There are two possible reasons for the asymmetric treatment. First, the MEC rules were developed in a relatively short period of time. To the surprise of tax practitioners who were involved in the consultation for MEC group rules, “the current quite liberal rules for MEC groups [were developed] after a consultation period of \textit{about a couple of months}” (emphasis added).\(^ {41}\) Apparently, the government was under intense time pressure as the rules were developed “in the last few months leading up to the release of the first instalment of the consolidation legislation”\(^ {42}\). Second, as the design of the consolidation regime was approaching conclusion, “the officials became more adventurous in what they were prepared to recommend to government ...”\(^ {43}\)

A.3.2 Problems at joining time

Problems of the TCS rules for MEC groups at joining time include:

\textit{(1) Conflicting objectives}

The special TCS rules for MEC groups contradicts the general objective of the TCS regime, namely to align acquisition costs of \textit{subsidiaries} to the costs of ...
their underlying assets. ETIs are by definition wholly-owned subsidiaries of the parent company. Treating them as the head company is a fiction that arguably has pushed the logic too far.

However, the deeming of all ETIs to be one single holding company is perhaps the pragmatic way to make the consolidation regime works for MEC groups. The fact is that no other countries in the world allow consolidation for foreign owned groups in this way, thus potentially making the Australian consolidation regime attractive to foreign multinational groups.

(2) Not neutral
The policy may be neutral between the choice of being an ETI of an existing MEC group or a head company of a new consolidated group. However, options are still wide open for corporate groups. For instance, the foreign parent company can choose between acquiring the company directly as an ETI or indirectly as a subsidiary of one of its existing ETIs. The latter option means that assets of the joining company would have their cost bases reset under the normal TCS rules.44 The tax outcomes of the two options would therefore be very different. The policy not only violates the policy objective of neutrality, but also creates tax planning opportunities for corporate groups.

(3) Transferring ETI up and down
The deeming of all ETIs as part of the head company raises the question of what should happen if an existing ETI is “transferred down” the group structure, and say becomes a subsidiary of another ETI. The issue is whether its share acquisition cost should be then pushed down to its assets. The

44 Surprisingly, the government was well aware of this possibility and almost seemed to be suggesting foreign groups to do so: EM to September 2002 Consolidation Act, paragraph 3.33.
question of “transferring up” a subsidiary and “promote” it to become an ETI is equally perplexing. The law does not provide clear answers to the questions.

A.3.3 Problems at leaving time

The logic of the TCS rules is again stretched by MEC groups at leaving time. As discussed in Section A.3.1 above, the cost bases of shares in ETIs are not reset at the joining or formation time. This policy not only contradicts the objective of the TCS rules of aligning the costs of shares and underlying assets of subsidiaries, but also creates problems at leaving time.

The question is what should the cost bases of shares in a leaving ETI be. As assets can be transferred tax free within a MEC group, keeping the original cost base of the shares would provide ample avoidance opportunities. For example, assets may be transferred to an ETI before the parent company sells the subsidiary to a third party. If the original cost bases of shares in the ETI is used to calculate the capital gain on the disposal, the assets would have been effectively transferred out of the group tax free.

Australia comes up with a bold solution. At the leaving time of an ETI, cost bases of shares in all ETIs are pooled together, then apportioned to leaving ETI based on its market value:\(^{45}\)

\[
\text{Deemed cost of shares in leaving ETI} = \frac{\text{pooled cost bases of shares in all ETI \times (market value of shares in the leaving ETI / market value of the MEC group)}}
\]

\(^{45}\) Section 719-570 ITAA1997. In particular, the cost resetting process is activated if (1) a ETI ceases to be a member of the MEC group, or (2) a CGT event (e.g. disposal) happens to shares in a ETI: s.719-555(1)(b) ITAA1997.
The government argued that such “resetting of the cost base from the pool facilitates the free transfer of assets within the group as it removes the need to make value shifting adjustments to the membership interests each time there is a transfer of value between MEC group members”.

Valuation is again required in the process, thus increasing the compliance costs. In addition, as valuation is more likely to be an art than science, it is doubtful if such redistribution of the pooled cost bases can effectively reflect the transfer of underlying assets within the group.

The formula determining cost bases of shares of the remaining ETIs in the MEC group is more puzzling. They are determined by spreading the remaining “pooled cost bases” evenly among the shares. The original cost bases of the shares are effectively redistributed among all the ETIs in an arbitrary manner.

This arbitrary cost base allocation policy may be acceptable in Australia, as gain on disposal of shares in ETIs by the non-resident parent company in most cases is not subject to tax. The non-taxability of future gains on shares in ETIs perhaps explains why the government is tolerant of the arbitrary allocation of cost bases between ETIs.

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46 EM to September 2002 Consolidation Act, paragraph 3.17.
47 Section 719-570(2) ITAA1997.
48 In general, capital gains derived by a non-resident on disposal of shares in a resident company are not subject to capital gains tax in Australia: Division 855 ITAA1997. Exceptions to the general rule include shares in a resident company whose assets are mainly Australian real property.
APPENDIX B
POLICY OPTIONS FOR THE TREATMENT OF ASSETS AT LEAVING TIME

This Appendix analyses, from a theoretical perspective, the alternative policy options for the treatment of assets at leaving time.

B.1 Policy options
In theory, alternative policy options of the treatment of assets at leaving time include:

(1) Quarantine
Under this alternative, tax attributes generated during consolidation would be quarantined at the group level. Pre-consolidation tax attributes that remain at leaving time are treated consistently, namely being quarantined at the subsidiary level. This alternative respects the transitions between the two doctrines and deals with the tax attributes accordingly.

(2) Recapture tax benefits under rollover
Rollover relief may have been allowed during consolidation and also at joining time. Under this policy, the tax benefits allowed under the rollover reliefs are recaptured at leaving time as the subsidiary is no longer part of the consolidated group.
Appendix B Policy Options for the Treatment of Assets at Leaving Time

(3) Deemed disposal
Under this alternative, assets taken by a leaving subsidiary away from a consolidated group would be deemed to have been disposed of to the subsidiary at market value. This policy option arguably provides a clear cut transition between the two doctrines.

(4) Rollover to leaving subsidiary
Under this policy option, the assets taken away by the leaving subsidiary from the consolidated group are rolled over to the former. There is no immediate tax implication at leaving time. Gain or loss on subsequent disposal of the asset is attributed wholly to the company.

The leaving issues under these alternative policy options are analysed below with the help of some examples, starting from the simplest scenario.

B.2 Scenario 1: Post-consolidation assets sold by subsidiary after leaving time
Assume a subsidiary of a consolidated group purchases an asset for $100 during consolidation, and leaves the group when the market value of the asset is $120 and eventually sells the asset for $150. The scenario is depicted below:
There are three alternative policies for this scenario:

(1) Quarantine

Under this alternative, the gain accrued during consolidation would be taxed in the hands of the group, while the gain accrued after subsidiary leaving would be taxed in the hands of the subsidiary. The timing of taxation is at the sale of the asset:

<table>
<thead>
<tr>
<th>Taxpayer</th>
<th>Taxable gain</th>
<th>Timing</th>
</tr>
</thead>
<tbody>
<tr>
<td>Group</td>
<td>$20</td>
<td>Upon sale of asset</td>
</tr>
<tr>
<td>Subsidiary</td>
<td>$30</td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>$50</td>
<td></td>
</tr>
</tbody>
</table>

The result is consistent with the transition from the enterprise doctrine to the separate entity doctrine. This alternative is also consistent with the realisation principle, that is, the gain of $50 is taxable only upon the actual disposal of the asset. Another advantage of this alternative is its deferral of taxing time rendering the regime more attractive to taxpayers.
However, this policy option has serious problems. Compliance and policing costs of tracing the asset and its market value until it is sold would likely to be significant. Another problem is that the value of the asset may fluctuate over time, as shown below:

**Diagram 33 Post-consolidation assets sold by subsidiary after leaving time – problem of value fluctuation**

<table>
<thead>
<tr>
<th>Purchase asset:</th>
<th>Market value</th>
<th>Sell asset:</th>
</tr>
</thead>
<tbody>
<tr>
<td>cost $100</td>
<td>$120</td>
<td>$80</td>
</tr>
</tbody>
</table>

The issue is how should the overall loss of $20 be allocated. A strict application of the quarantine policy would suggest the following:

<table>
<thead>
<tr>
<th>Taxpayer</th>
<th>Gain/(loss)</th>
<th>Timing</th>
</tr>
</thead>
<tbody>
<tr>
<td>Group</td>
<td>$20</td>
<td>Upon sale of asset</td>
</tr>
<tr>
<td>Subsidiary</td>
<td>$(40)</td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>$(20)</td>
<td></td>
</tr>
</tbody>
</table>

It would appear inappropriate to tax the group on the $20 "gain" while in fact the asset is disposed of at a loss of $20. Levying tax on the “never-realised” gain at the time of actual disposal at a loss would be difficult to justify, and be regarded as unfair.
(2) Deemed sale
Under this alternative, the asset is deemed to have been sold by the consolidated group to the subsidiary at market value at leaving time. The tax consequences can be summarised as follows:

<table>
<thead>
<tr>
<th>Taxpayer</th>
<th>Taxable gain</th>
<th>Timing</th>
</tr>
</thead>
<tbody>
<tr>
<td>Group</td>
<td>$20 (unrealised)</td>
<td>Upon leaving</td>
</tr>
<tr>
<td>Subsidiary</td>
<td>$30</td>
<td>Upon sale of asset</td>
</tr>
<tr>
<td>Total</td>
<td>$50</td>
<td></td>
</tr>
</tbody>
</table>

This alternative is also consistent with the transition between the two doctrines. The problem of this alternative is that it violates the realisation principle by taxing unrealised gain of $20 at the leaving time. Corporate groups are unlikely to welcome immediate taxation of unrealised gains.

The "never-realised gain" issue also applies to this alternative. If the asset is subsequently sold by the ex-subsidiary for $80 after leaving the consolidated group, the tax outcome would be as follows:

<table>
<thead>
<tr>
<th>Taxpayer</th>
<th>Gain/(loss)</th>
<th>Timing</th>
</tr>
</thead>
<tbody>
<tr>
<td>Group</td>
<td>$20 (unrealised)</td>
<td>Upon leaving</td>
</tr>
<tr>
<td>Subsidiary</td>
<td>$(40)</td>
<td>Upon sale of asset</td>
</tr>
<tr>
<td>Total</td>
<td>$(20)</td>
<td></td>
</tr>
</tbody>
</table>

The tax outcome is basically the same as for the quarantine alternative, except that the taxing time of the unrealised gain of $20 is accelerated. In this respect, one may argue that this policy is less friendly to taxpayers. However, governments may prefer this option as the regime would be simpler to
administer since it is not necessary to trace the asset until actual disposal by the ex-subsidiary.

(3) Rollover to leaving subsidiary
The tax outcome under this scenario is as follows:

<table>
<thead>
<tr>
<th>Taxpayer</th>
<th>Gain/(loss)</th>
<th>Timing</th>
</tr>
</thead>
<tbody>
<tr>
<td>Group</td>
<td>$0</td>
<td></td>
</tr>
<tr>
<td>Subsidiary</td>
<td>$50</td>
<td>Upon sale of asset</td>
</tr>
<tr>
<td>Total</td>
<td>$50</td>
<td></td>
</tr>
</tbody>
</table>

The advantage of this policy option is simplicity. No tracing or valuation of the asset is required. However, it violates the enterprise doctrine, as the rollover relief should apply only if the subsidiary remains to be part of the consolidated group. Furthermore, the deferral of the taxation time until the actual disposal of the asset by the subsidiary may not be acceptable to most governments.

B.3 Scenario 2: Pre-consolidation asset sold by subsidiary after leaving time
The second scenario is more complicated as it involves pre-consolidation assets. Assume that a company purchases an asset at $100, and then joins a consolidated group when the market value of the asset is $120. The subsidiary leaves the group when the asset has a market value of $180, and eventually sells the asset for $200. The asset remains in the hands of the subsidiary throughout the whole period. The scenario can be depicted as follows:
There are several alternative policies for this scenario:

(1) Quarantine
Under this alternative, the total gain of $100 is attributed to the subsidiary and the consolidated group as follows:

<table>
<thead>
<tr>
<th>Taxpayer</th>
<th>Taxable gain</th>
<th>Timing</th>
</tr>
</thead>
<tbody>
<tr>
<td>Group</td>
<td>$60</td>
<td></td>
</tr>
<tr>
<td>Subsidiary</td>
<td>$40</td>
<td>Upon sale of asset</td>
</tr>
<tr>
<td>Total</td>
<td>$100</td>
<td></td>
</tr>
</tbody>
</table>

This alternative again is consistent with both the transitions between the two doctrines and the realisation principle. However, the compliance and policing costs would likely to be significant and the potential taxation of "never realised gain" is problematic.

(2) Rollovers at both joining and leaving time
Under this alternative, the cost base of the asset is rolled over to the consolidated group at joining time. At leaving time, the cost base is again
rolled over to the subsidiary. The tax implication is summarised in the following table:

<table>
<thead>
<tr>
<th>Taxpayer</th>
<th>Taxable gain</th>
<th>Timing</th>
</tr>
</thead>
<tbody>
<tr>
<td>Group</td>
<td>$0</td>
<td></td>
</tr>
<tr>
<td>Subsidiary</td>
<td>$100</td>
<td>Upon sale of asset</td>
</tr>
<tr>
<td>Total</td>
<td>$100</td>
<td></td>
</tr>
</tbody>
</table>

This alternative fails to reflect the transitions between the two doctrines, as the portion of gains attributable to the period of consolidation is still taxed in the hands of the subsidiary. However, it is relatively simple compared to the others. Taxpayers would welcome the deferral of the taxing time until actual disposal of the asset. In contrast, governments may be less enthusiastic to the deferral of taxing time, and may prefer to recapture the deferred gain at leaving time.

(3) Rollover at joining time and recapture at leaving time

Under this alternative, the cost base of the asset is rolled over to the group at joining time. At leaving time, gain accrued during consolidation is taxed in the hands of the group. The tax outcome is summarised as follows:

<table>
<thead>
<tr>
<th>Taxpayer</th>
<th>Taxable gain</th>
<th>Timing</th>
</tr>
</thead>
<tbody>
<tr>
<td>Group</td>
<td>$80 (unrealised)</td>
<td>Upon leaving</td>
</tr>
<tr>
<td>Subsidiary</td>
<td>$20</td>
<td>Upon sale of asset</td>
</tr>
<tr>
<td>Total</td>
<td>$100</td>
<td></td>
</tr>
</tbody>
</table>

This alternative is inconsistent with the transition between the two doctrines at joining time, as the $20 gain accrued before the joining time is taxed in the hands of the group, instead of the subsidiary. The taxation of unrealised gain
of $80 is also problematic, namely violating the realisation principle and suffering from the “never-realised gain” issue. However, this alternative has the advantage of avoiding tracing assets after the leaving time.

(4) Deemed sale
Under this alternative, the asset is deemed to have been sold at market value at both joining and leaving time. The tax implications are as follows:

<table>
<thead>
<tr>
<th>Taxpayer</th>
<th>Taxable gain</th>
<th>Timing</th>
</tr>
</thead>
<tbody>
<tr>
<td>Subsidiary</td>
<td>$20 (unrealised)</td>
<td>Upon joining</td>
</tr>
<tr>
<td>Group</td>
<td>$60 (unrealised)</td>
<td>Upon leaving</td>
</tr>
<tr>
<td>Subsidiary</td>
<td>$20</td>
<td>Upon sale of asset</td>
</tr>
<tr>
<td>Total</td>
<td>$100</td>
<td></td>
</tr>
</tbody>
</table>

This alternative is consistent with the transitions between the two doctrines, but violates the realisation principle. Taxation of unrealised gain would suffer from the disadvantages discussed above.

B.4 Scenario 3: Pre-consolidation asset sold by subsidiary after intra-group transfer and after leaving time
In this scenario, Subsidiary 1 purchases an asset before joining time, and transfers it to Subsidiary 2 during consolidation. Subsidiary 2 then leaves the group and sells the assets. The scenario can be depicted in the following diagram:
Appendix B Policy Options for the Treatment of Assets at Leaving Time

Diagram 35 Pre-consolidation assets sold by subsidiary after intra-group transfer and after leaving time

S1 buys asset: cost $100
m.v. $120

Transfer asset from S1 to S2 when m.v. = $160
m.v. $180

Consolidation

S2 sells asset: $200

Under consolidation, the intra-group transfer of asset would be tax neutral in accordance with the enterprise doctrine. There are again a number of alternative policies for this scenario:

(1) Quarantine
Under this alternative, gains accrued during ownership by S1, S2 and the consolidated group are quarantined. The tax outcome is summarised as follows:

<table>
<thead>
<tr>
<th>Taxpayer</th>
<th>Taxable gain</th>
<th>Timing</th>
</tr>
</thead>
<tbody>
<tr>
<td>S1</td>
<td>$20</td>
<td></td>
</tr>
<tr>
<td>Group</td>
<td>$60</td>
<td>Upon sale of asset</td>
</tr>
<tr>
<td>S2</td>
<td>$20</td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>$100</td>
<td></td>
</tr>
</tbody>
</table>

This alternative is consistent with both transitions between the two doctrines and the realisation principle. The table also shows that the quarantine policy identifies precisely the taxpayers corresponding to each period of ownership. Its advantages and disadvantages are basically the same as those for Scenario 2(1) above.
(2) Rollovers at joining time, intra-group transfer and leaving time
Similar to Scenario 2(2) above, the tax outcome is that the whole amount of gain of $100 is taxed in the hands of S2. It fails to reflect properly the transitions between the two doctrines, and has basically the same advantages and disadvantages as Scenario 2(2).

One important difference with Scenario 2(2) is that by transferring the asset from S1 to S2 tax free, the tax liability on the whole amount of $100 gain is shifted to S2. This creates avoidance opportunities. Specific anti-avoidance rules would be required to deal with abuse.

(3) Rollover at joining time and intra-group transfer, and recapture at leaving time
Again, similar to in Scenario 2(3) above, the tax outcome can be summarised as follows:

<table>
<thead>
<tr>
<th>Taxpayer</th>
<th>Taxable gain</th>
<th>Timing</th>
</tr>
</thead>
<tbody>
<tr>
<td>Group</td>
<td>$80 (unrealised)</td>
<td>Upon leaving</td>
</tr>
<tr>
<td>S2</td>
<td>$20</td>
<td>Upon sale of asset</td>
</tr>
<tr>
<td>Total</td>
<td>$100</td>
<td></td>
</tr>
</tbody>
</table>

This alternative fails to reflect properly the transition between the two doctrines at joining time, and violates the realisation principle. It has basically the same advantages and disadvantages as Scenario 2(3) above.

A variation of this scenario is to allow rollovers until the asset leaves the group, but the taxable amount at the leaving time is only the amount of rollover allowed at the time of intra-group transfer (i.e. $60):
(4) Deemed sales

The tax outcome under this alternative can be summarised as follows:

<table>
<thead>
<tr>
<th>Taxpayer</th>
<th>Taxable gain</th>
<th>Timing</th>
</tr>
</thead>
<tbody>
<tr>
<td>S1</td>
<td>$20 (unrealised)</td>
<td>Upon joining</td>
</tr>
<tr>
<td>Group</td>
<td>$60 (unrealised)</td>
<td>Upon leaving</td>
</tr>
<tr>
<td>S2</td>
<td>$20</td>
<td>Upon sale of asset</td>
</tr>
<tr>
<td>Total</td>
<td>$100</td>
<td></td>
</tr>
</tbody>
</table>

Despite properly reflecting transitions between the two doctrines, this alternative violates the realisation principle. It has basically the same advantages and disadvantages as Scenario 2(4) above.

B.5 Summary

The advantages and disadvantages of the alternative policy options of the treatment of assets at leaving time are summarised in Table 12 below:
### Table 12 Alternative policy options for the treatment of assets at leaving time

<table>
<thead>
<tr>
<th>Policy option</th>
<th>Transition between the two doctrines</th>
<th>Realisation principle</th>
<th>Attractiveness to taxpayers</th>
<th>Simplicity</th>
</tr>
</thead>
<tbody>
<tr>
<td>Quarantine</td>
<td>✓</td>
<td>✓</td>
<td>✓ / X</td>
<td>X</td>
</tr>
<tr>
<td>Rollovers</td>
<td>X</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>Rollover + Recapture</td>
<td>✓ / X</td>
<td>✓</td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td>Deemed Sale</td>
<td>✓</td>
<td>X</td>
<td>X</td>
<td>X</td>
</tr>
</tbody>
</table>

Note:
1. The quarantine policy is attractive to taxpayers as the taxation time is deferred until actual disposal of the assets. However, the possibility of taxing “never realised gains” reduces its attractiveness.

2. The “rollover + recapture” policy respects the transition between the two doctrines at leaving time, but fails to do so at joining time.

The above analysis suggests that the quarantine option is theoretically superior but practically a nightmare. The complexity of tracing assets after leaving time and the recalculation of gains attributable to different taxpayers (for example, the group and subsidiaries) is unlikely to be acceptable in practice.
This Appendix supplements Chapter 11 providing more information and analysis of the problems of the multilateral FA model, drawing substantially from the experience of the Common Consolidated Corporate Tax Base ("CCCTB") project in the EU and the documents produced by the CCCTB Working Group. The extensive consultation and sometimes heated debates on the proposed CCCTB regime provide a unique and significant opportunity to highlight the problems of applying the multilateral FA model in the real world. This Appendix, together with Chapter 11, serves to document this reality check of the model.

To facilitate the discussion of the numerous issues, the analysis is structured around four major categories of problems of the multilateral FA method, as depicted in Diagram 36 below:
Diagram 36 Four categories of problems of the multilateral FA model

The four categories of problems are:

1. arbitrariness;
2. complexity;
3. tax avoidance; and
4. political resistance.

C.1 Arbitrariness
The critical issue of a cross-border FA model is the allocation of tax base among jurisdictions. The mismatch between the political spans of jurisdictions and the economic spans of corporate groups is the core issue of
any taxation systems for multinational corporate groups. The allocation exercise has been described to be as difficult as “slicing a shadow”.¹

An arbitrary allocation of tax base would produce unfair results. Fairness is one of the cornerstones of an international income tax system.² Although the concept of fairness is more readily applied to individual taxpayers, a corporation is an “essential halfway house” for income flowing to individual shareholders and similar principles should apply to its taxation.³ As shown below, the group-bloc model can produce arbitrary and thus unfair allocation of tax base among jurisdictions. The arbitrariness of a multilateral FA model is caused primarily by the following issues:

1. different income-generating power of factors between jurisdictions;
2. different income-generating factors for passive and active business income;
3. mechanical generic formula;
4. multiple-business corporate groups;
5. different income-generating factors for specific industries;

² Michael J Graetz, “The David R. Tillinghast lecture: Taxing International income: inadequate principles, outdated concepts, and unsatisfactory policies” (2001) 54(Spring) Tax Law Review 261, at 307. This is not the place for detailed discussion of the concept of fairness, especially in international context. There is huge literature on the issue, see for example the classic work of Musgraves: Richard A Musgrave and Peggy B Musgrave, “Inter­nation Equity” in Richard M Bird and John F Head (eds), Modern Fiscal Issues: Essays in Honor of Carl S. Shoup (1972, University of Toronto Press, Toronto) ; and Graetz, ibid, at 297-307.
(6) scope of factors: theory vs reality;
(7) valuation of factors: theory vs reality; and
(8) interaction between the enterprise doctrine and the separate entity doctrine: “no-where sales”.

Each of these issues is discussed in more detail below.

C.1.1 Different income-generating power
of factors between jurisdictions

This problem arises due to the different productivity and profitability of each dollar of payroll, property and sales between jurisdictions. A fundamental underlying assumption of a generic allocation formula under the FA method is that the income-generating power of factors is the same in every jurisdiction. This is clearly wrong. For instance, the fact that multinationals have been racing to set up manufacturing facilities in China suggests strongly that a dollar of payroll cost spent in China has a very different profitability implications to a dollar of payroll cost in, for example, the U.S. Allocation of tax base under the fundamentally wrong assumption would inevitably produce arbitrary results.

Theoretically, the formula may incorporate adjustments to reflect the different income-generating power of factors in different jurisdictions. However, it would create complexity and controversies, and no system in practice has such an adjustment mechanism. On this issue, one should be careful in relying on existing models (such as those in the U.S. states). Differences in productivity and profitability are greater on a global than on a domestic basis. The distortion is magnified if one attempts to apply the FA method currently

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4 Coffill & Willson Jr, above note 1, at 1116.
5 Ibid.
adopted by sub-federal governments in a relatively homogeneous county (for example, states in the U.S.) to a regime covering different countries. In summary, a cross-border FA method without adjustments for income-generating power in different jurisdictions is fundamentally flawed.

The EC faced serious problems on this issue. In particular, it was controversial when some Member States argued for adjustments in the formula to compensate for the different wage levels among jurisdictions. This particular issue is analysed in more detail in the discussion of the "payroll" factor in Section C.2.4.2.4.2(c) below.

C.1.2 Different income-generating factors for passive and active business income

The primary objective of the FA method is to allocate tax base of a group to jurisdictions according to the income-generating factors located in each jurisdiction. The traditional 3-factor formula (namely payroll, asset and sales) "was developed primarily for manufacturing and mercantiling companies". It is questionable if such a formula is appropriate to allocate passive income and capital gains, or even business income of service industries. For example, it may be argued that capital gains on disposal of immovable property should be allocated exclusively to the country where the property is located. It is equally convincing to argue that passive income, such as dividend income, should not be allocated based on factors such as payroll, assets and sales.

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6 For example, see European Commission, "CCCTB: possible elements of the sharing mechanism" (CCCTB\WP\060, CCCTB WG, 2007) ("WP60"), paragraph 26.


8 European Commission, "The mechanism for sharing the CCCTB" (CCCTB\WP\047, CCCTB WG, 2006) ("WP47"), paragraph 8.
Royalty income provides an interesting example. On one hand, intangible assets are typically excluded from the "asset" factor due to practical concerns (for example, difficult to determine its location and valuation; and prone to manipulation). On the other hand, royalty income that they generate is in general included in the tax base to be allocated by the formula. This arguably violates the fundamental theory of the FA method, which aims to allocate the tax base according to the factors generating that tax base. If royalty income generated by an intangible asset is allocated based on a formula that does not include that intangible asset as a factor, the result would be detached from economic reality.

The issue represents a dilemma for the FA method. If a formula – which is primarily designed for active business income – is applied to passive income, the resulting allocation would be arbitrary and contradict with the objective of the FA method. However, if different formulae are used for active and passive income, the system would be more complex and subject to disputes. For instance, countries may disagree on the classification of particular items of income (for example, substantial capital gain from sale of subsidiary), as the classification would determine which country can collect the tax revenue.

The EC experts are divided on this issue. While the Commission is inclined towards a generic formula for all types of income, some experts believe that "non-business income (mainly passive income such as interest, royalties and

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9 For experience in the U.S. on this issue, see Michael J McIntyre, "The Use of Combined Reporting by Nation States" (2004) 35 Tax Notes International 917, at 922. Some states even exclude disposal proceeds from sale of intangibles from the "sales" factor: ibid.

10 This system of multiple allocation methods was suggested by Paul McDaniel for NAFTA region: McDaniel, above note 7, at 720-722.

dividends) [should] be allocated directly to the [Member State] of source ...".\textsuperscript{12} The latter position is arguably the better position as it would produce a fairer allocation of the tax base. However, the EC is not in favour of it, believing that a generic formula approach “is the simplest one”.\textsuperscript{13}

In practice, many FA formulae currently used by states in the U.S. do distinguish between passive and active income. This is due to constitutional limitations on the taxation of non-business income by the states.\textsuperscript{14} However, such limitation would not be relevant to cross-border FA systems at federal level.

The generic formula approach is likely to be the model to be proposed by the EC.\textsuperscript{15} The resulting allocation is therefore bound to be arbitrary and unfair.

C.1.3 Mechanical generic formula

Under the enterprise doctrine, the taxable unit is the group as a whole instead of individual group members. The group’s worldwide profit is therefore the tax base to be allocated to jurisdictions that have taxing rights under the FA regime. A generic formula that is applicable to most cases and acceptable to all parties concerned is a necessary component of a viable FA system:\textsuperscript{16}

\begin{itemize}
\item \textsuperscript{12} WP60, paragraph 15.
\item \textsuperscript{13} European Commission, “Report and overview of the main issues that emerged during the discussion on the sharing mechanism” (CCCTB\WP\056, CCCTB WG, 2007) (“WP56”), paragraph 5.
\item \textsuperscript{14} The distinction caused enormous “complexities of classifying various items of income as business or non-business income”: Coffill & Willson Jr, above note 1, at 1112. See also McIntyre, above note 9, at 946.
\item \textsuperscript{15} The EC proposed that “all taxable income, i.e. business and non-business income, earned by the group should be consolidated and apportioned on the basis of the given formula ...”: WP60, paragraph 15.
\end{itemize}
any viable new international tax order [for direct investment] must to a large extent rest on precisely the ... worldwide allocation approach ... What is needed ... to make such a system viable is primarily agreement on the formula by all parties concerned.

Unfortunately, such a generic formula is bound to be arbitrary and fail to take into account specific circumstances of each corporate group. Take an example of a mining group in Australia selling its products to the U.S. What should be a fair allocation of its worldwide profits between Australia and the U.S. under a FA system? The essential weakness of a FA system is that it is not a standard at all. Unlike the arm's length standard, it provides no guidance on what the appropriate allocation should be. Each of the following mutually exclusive allocation methods is equally consistent with the FA method:

(i) Australia taxes all profits based on one single allocation factor: "asset".
(ii) The U.S. taxes all profits based on one single allocation factor: "sales by destination".
(iii) Australia and the U.S. share the group's profits based on the traditional three-factor formula: asset, payroll and sales.

The example illustrates that "there is vast room for honestly held and irreconcilable differences between sovereigns over the results that formula apportionment should produce"; the FA method is therefore dubbed as a "design for disagreement".

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17 Wilkins & Gideon, above note 1, at 1261. The following example is based on the example in the article.
18 A single factor of "sales by origin" would produce the same result.
19 Wilkins & Gideon, above note 1, at 1261.
an unfair apportionment”. However, some “old Member States” disagreed and argued that, among other things (emphasis added).

... this adjustment would not be justified, because ... there should be a convergence [of the wage levels] in the medium term ...

There are two problems with this “long-term” argument. First, the claim that all countries would have net gain from the new FA system in the long term does not seem to be supported by research. Second, even if the claim is correct, it is doubtful if countries are willing to sacrifice in the short term for the “long term” common good.

Many Member States are so concerned about the revenue impact of the CCCTB that they are preparing analysis of the likely impact themselves, even though the EC is conducting an EC-wide “impact assessment” as part of its

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67 This is not surprising as empirical studies tend to confirm that “the differences between the relative shares of the number of employees [among EU countries] and the relative shares of the cost of employees are particularly pronounced for the new member states ...”: see for example Devereux & Loretz, ibid, at 10.

68 CCCTB WP56, paragraph 16.

69 It is clear that some countries will not be willing to sacrifice in this way. For example, Ireland prevents any “short term” pain by rejecting the CCCTB proposal outright: Faith, above note 37. Also, member states that supported adjustment to the wage levels argued that “it would take many years for wage levels in the EU to be comparable, whereas the consequences on the tax base distribution would be immediate” (emphasis added): CCCTB WP59, paragraph 9.
work on the proposed regime.\textsuperscript{70} Some are also sceptical about the accuracy of the EC impact assessment.\textsuperscript{71}

\textbf{(2) Removal of traditional tax policy tools}

Another reason for jurisdictions objecting to the FA method is the removal of traditional tax policy tools. For instance, countries may offer, for national interest, tax incentives to multinational corporate groups, for example preferential corporate tax rate for foreign manufacturing companies, and specific tax incentives for holding companies.\textsuperscript{72} It is not surprising that Ireland has been vigorously opposing to the CCCTB proposal from the beginning.\textsuperscript{73}

Empirical studies tend to support the position that countries known for offering attractive tax incentives to multinational corporate groups would lose tax base if an FA model is introduced.\textsuperscript{74}

\textbf{(3) Administrative issues}

Another area where national interests may collide is the administration system of a multilateral FA model. For instance, if a group’s tax base is allocated to twenty countries under the model, and the group objects to the assessment, the

\textsuperscript{70} It is interesting to note that the EC seemed to be surprised when it found out that some Member States were working on their own assessment: CCCTB WP59, paragraph 63. Germany is reported to be one of the countries that has commissioned such an assessment, and the result is not encouraging: Faith, ibid. For an example of the empirical studies estimating the impact of CCCTB, see Clemens Fuest, Thomas Hemmelgarn and Fred Ramb, “How would the introduction of an EU-wide formula apportionment affect the distribution and size of the corporate tax base? An analysis based on German multinationals” (2007) 14(5) International Tax and Public Finance 605.

\textsuperscript{71} For the problems of collecting data from member states, see CCCTB WP59, paragraphs 66-72.

\textsuperscript{72} For example, see Fuest, above note 70, at 617-618.

\textsuperscript{73} Faith, above note 37.

\textsuperscript{74} Fuest, above note 70, at 617.
question is how the dispute should be resolved. Which country (or countries) should be in charge of the negotiation with the group? If the twenty countries have different opinions, should the dispute be resolved on a majority basis? These issues arise due to the cross-border nature of a multilateral FA model. 75

The CCCTB experience on the administration issues confirms that they are problematic and controversial. The basic administrative structure proposed by the EC is that the ultimate parent company of the group would be the “principal taxpayer” who would file the consolidated tax return to the tax authority of the Member State of residence (“the principal tax authority”). 76

While providing in general support to the idea of “harmonised rules on the administrative framework so as to avoid tax administration shopping”, Member States have raised many questions “relating to the various bodies [for example, central body for issuing interpretation] suggested ... as well as the need to regulate the panels, their functioning, ... and the people who could sit on different bodies” (emphasis added). 77 It is not surprising that, on the issue of joint audit, “many questions were raised as to the relationship between the principal tax authority and the other competent authorities” (emphasis added). 78 The EC provided a diplomatic answer: “a fair balanced relationship

75 A FA system had been proposed for the North American Free Trade Zone and the proponent acknowledged that such a system “would work only if binding decisions could be made [under a mechanism resolving disputes between the countries and the taxpayers] that would prevent any treaty country from adopting domestic rules producing double (or no) taxation ... within the NATFA zone”: McDaniel, above note 53, at 707. McDaniel also acknowledged that such an administrative mechanism would be very complex, as he commented that “[o]bviously, one could write a book solely about the concept of a NATFA Tax Commission ...”: ibid, at 725.

76 CCCTB WP59, paragraph 35.

77 European Commission, “Summary record by the chair of the meeting of the common consolidated corporate tax base working group” (CCCTB\WP\64, CCCTB WG, 2008) (“CCCTB WP64”), paragraphs 28-29.

78 Ibid, paragraph 34. Questions included: (a) what if a national authority wished to launch an enquiry into companies in their territory without agreement or even referring to the principle
has to be established so as to *prevent the principal tax authority from deciding everything*” (emphasis added). It is unclear if the answer provides any comfort to Member States.

Different penalty regimes at the national level serve as another example of the potential conflicts between jurisdictions. The lack of an EU-wide common penalty regime would encourage “undesirable competition between MS and therefore lead to some kind of *penalties shopping*” (emphasis added). However, the EC believes that as “the actual source of legislation for penalties in many MS does not necessarily come straight from tax legislation ... arriving at a common approach on [penalties] would be too complicated and therefore not feasible”.

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79 CCCTB WP64, paragraph 34.

80 The OECD has produced the “Model Agreement for the Undertaking of Simultaneous Tax Examinations” in 1992 (available at http://www.oecd.org/dataoecd/8/0/2666483.pdf, accessed on 27 October 2008). However, there are important differences between the Model Agreement and the proposed joint audit procedures under CCCTB. First, the Model Agreement is designed for audits to be conducted simultaneously but “independently”, meaning that each jurisdiction will conduct the audit only within “its own territory” and “the examinations will be conducted separately within the framework of national law and practice” (emphasis added): Articles A & E of Model Agreement. In other words, there is much less conflict with national interest as compared to the CCCTB proposal. Second, each jurisdiction is free to decide whether to participate in a joint audit on a particular taxpayer under the Model Agreement: Article C(3) of Model Agreement. Countries under the CCCTB regime would not have this flexibility. Third, it is possible to have double taxation resulting from joint audits under the Model Agreement: Article G of Model Agreement. This is not possible under the CCCTB regime, as it is a zero-sum game. It is therefore understandable that the Member States are quite concerned about the administration system under CCCTB, and the OECD Model Agreement may not offer much comfort.

81 CCCTB WP63, paragraph 10. Some Member States are also concerned about “principal tax authority shopping”: see Appendix C Section C.4.3.

82 Ibid, paragraph 10.
The multilateral FA model is made more political as the formula effectively imposes an “implicit tax” on the factors, and thus can affect the behaviour of multinational groups.\(^\text{83}\) For instance, a formula with property and payroll as factors “discourages assets and employment in high-tax locations”.\(^\text{84}\)

A look at the history in the EU does not offer an optimistic outlook. Up until the current effort of the EC on CCCTB, “although member states have been working together since 1957, the introduction of a common tax base never seemed to be a realistic option”.\(^\text{85}\) The postponement of the CCCTB legislative proposal in August 2008, to someone familiar with the history, should come as no surprise.

Brown provided a good summary of the political difficulties of implementing a multilateral FA system:\(^\text{86}\)

Negotiations would be particularly difficult because there is no principled basis for resolving many ... issues, which are simply policy issues affecting the allocation of income among jurisdictions for tax purposes. Given the complexity and the economic interests at stake, it is highly unlikely that consensus could be reached. Arm’s length pricing at least has a unifying principle – the price that would have been charged between unrelated parties – whatever its difficulty in application. The lack of a comparable principle in formulary taxation

\(^\text{83}\) See for example Wolfgang Schön, “Group Taxation and the CCCTB” (2007) 48(11) Tax Notes International 1063, at 1078; Martens-Weiner, above note 16. For examples of empirical studies on this issue, see Martens-Weiner, ibid, at 95-97.

\(^\text{84}\) Avi-Yonah & Clausing, above note 16, at 11.


\(^\text{86}\) Brown, above note 55, at 768.
makes the international implementation of such a system practically impossible.

Almost forty years ago, an UN report stated that “even in a federal union, such as the United States, no agreement [on a formula] could be reached between the states. The task of bringing about an agreement ... at an international level would be even more formidable ...”\textsuperscript{87} Ten years ago, the OECD rejected the FA method for the following reasons (emphasis added):\textsuperscript{88}

The most significant concern with global formulary appointment is the difficulty of implementing the system in a manner that both protects against double taxation and ensures single taxation. To achieve this would require substantial international coordination and consensus on the predetermined formulae to be used and on the composition of the group in questions ... Reaching such agreement would be time-consuming and extremely difficult ... Even if some countries were willing to accept global formulary apportionment there would be disagreements [on] factors in the formula ... Each country would have a strong incentive to devise formulae ... that would maximise that country’s own revenue ... The transition to a global formulary apportionment system therefore would present enormous political and administrative complexity and require a level of international cooperation that is unrealistic to expect in the field of international taxation.

\textsuperscript{87} United Nations, The Impact of Multinational Corporations on Development and on International Relations (1974, UN, New York), at 93.

Chapter II Multilateral Consolidation: CCCTB Experience

The CCCTB experience suggests that the political constraint continues to be a formidable obstacle to a multilateral application of the enterprise doctrine.

11.5.2 Arbitrariness

One of the arguments for the multilateral FA model is that the transfer pricing rules are arbitrary. However, the model itself does not score much better in terms of arbitrariness. Even proponents of the model concede that the formula is "inherently arbitrary". It may allocate profits to a country where profits were not earned. For example, a group may genuinely incur losses in a country while the group overall is profitable. Contrary to economic reality, the formula also assumes "equal productivity and proceeds for all production factors".

A critical issue of the multilateral FA model is the allocation of tax base among jurisdictions. The allocation exercise has been described as difficult as "slicing a shadow". In contrast to transfer pricing rules which produce adjustments that are tailor-made for a particular group, a multilateral FA model makes allocation based on a uniform formula applicable for all eligible

89 Avi-Yonah & Clausing, above note 16, at 22. Li made the same concession, but argued that the model "would be more certain": Li, above note 16, at 844.

90 Some proponents of the model concede that this is indeed possible, but still argue that it is "fallacious ... to conclude that the designers of [the model] have indulged in some counterfactual assumption about the way income is earned within a corporate group": McIntyre, above note 16, at 922. Others attempt to argue that these anomalies "should be eliminated in the long-run as profit maximizing companies relocate their investment until rates of return are equalized across locations" (emphasis added): Martens-Weiner, above note 16, at 42.

91 Schön, above note 83, at 1078.

groups in every participating country. As every group is different, the allocation is bound to be arbitrary.

The major reasons why a multilateral FA model is arbitrary include:

(1) different income-generating power of factors across jurisdictions;
(2) different income-generating factors for passive and active business income;
(3) mechanical generic formula;
(4) multiple-business corporate groups;
(5) scope of factors: theory vs reality;
(6) valuation of factors: theory vs reality; and
(7) "no-where sales": interaction between the two doctrines.

(1) Different income-generating power of factors in different jurisdictions

This problem arises due to differences in the productivity and profitability of each dollar of payroll, asset and sales between jurisdictions.93 As discussed above in the context of political resistance, the issue was highly controversial when some Member States argued for adjustments in the CCCTB allocation formula to compensate for the different wage levels among jurisdictions.94

93 Coffill & Willson Jr, above note 92, at 1116. See Appendix C Section C.1.1 for more detailed discussion of the issues.
94 CCCTB WP60, paragraph 26.
(2) Different income-generating factors for passive and active business income

The primary objective of the FA method is to allocate tax base of a group to jurisdictions according to the income-generating factors located in each jurisdiction. The traditional 3-factor formula (namely payroll, asset and sales) "was developed primarily for manufacturing and mercantiling companies". It is questionable if such a formula is appropriate to allocate passive income and capital gains, or even business income of service industries. During the CCCTB consultation process, it has been suggested that capital gains on disposal of immovable property should be allocated exclusively to the country where the property is located. However, if different formulae are used for active and passive income, the system would be more complex and subject to disputes. For instance, countries may disagree on classification of particular items of income (for example, substantial capital gain from sale of subsidiary), as the classification would determine which country would collect the tax revenue.

While the EC inclines towards a generic formula for all types of income, some experts believe that "non-business income (mainly passive income such as interest, royalties and dividends) [should] be allocated directly to the [Member State] of source ...". However, the EC is not in favour of it, believing that a generic formula approach "is the simplest one".

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95 McDaniel, above note 53, at 710.
96 CCCTB WP47, paragraph 8.
97 This system of multiple allocation methods was suggested by Paul McDaniel for NAFTA region: McDaniel, above note 53, at 720-722.
98 Brown, above note 55, at 763.
99 CCCTB WP60, paragraph 15.
100 CCCTB WP56, paragraph 5. For more discussion of this issue, see Appendix C Section C.1.2.
(3) Mechanical generic formula\textsuperscript{101}

A generic formula that is applicable to most cases and acceptable to all parties concerned is a necessary component of a viable FA system.\textsuperscript{102} Unfortunately, such a generic formula is bound to be arbitrary and fail to take into account specific circumstances of each corporate group.

The EC recognises that the “mechanical” nature of the generic formula can be problematic, and proposes a “safeguard clause” to avoid “unfair” results.\textsuperscript{103} Interestingly, the proposal is the result of “strong and unanimous recommendation by the U.S. and Canadian tax administrations”.\textsuperscript{104} Based on actual implementation experience, they are well aware that “it is practically inevitable that specific individual cases would arise where the standard allocation formula would lead to results that would be perceived to be ‘unfair’”.\textsuperscript{105}

It is doubtful if the clause would be effective in practice, as its application is intended to be very restrictive. The clause would apply only in “very exceptional cases” and any adjustment “should be commonly agreed by the tax administrations concerned and not be granted ... unilaterally”.\textsuperscript{106} Experience in the U.S. is not encouraging. The safeguard clause is rarely

\textsuperscript{101} For more detailed discussion of this issue, see Appendix C Section C.1.3.
\textsuperscript{103} CCCTB WP60, paragraph 71.
\textsuperscript{104} CCCTB WP59, paragraph 30. Some EU experts “remain rather sceptical” of the need for such clause: CCCTB WP56, paragraph 42.
\textsuperscript{105} CCCTB WP56, paragraph 42.
\textsuperscript{106} CCCTB WP60, paragraph 71.
invoked at the request of taxpayers, and even when it is invoked the relief is "granted, if at all, only after litigation is instigated by a taxpayer".\(^{107}\)

(4) **Multiple-business corporate groups**
In the modern commercial world, it is not uncommon for multinationals to have several lines of businesses. If one single formula is used to allocate the group's worldwide profits to jurisdictions, the result is bound to be arbitrary as the income-generating factors for each business line would likely to be different.

One solution proposed by the EC is to apply industry-specific formulae to certain industries, such as "financial services, transportation services such as airlines and railways, and television and broadcasting services".\(^{108}\) This approach is pragmatic but has two problems. First, it makes the FA regime more complex. Second, and perhaps more importantly, the approach brings back the problems of transfer pricing: the "devil" that the FA method is designed to conquer. To separate a group into different businesses and allocate income and expenses among them would inevitably encounter the familiar transfer pricing issues.

(5) **Scope of factors: theory vs reality**
In theory, the allocation formula should incorporate all relevant and significant factors to reflect their income-generating power. However, in practice, that is far from the truth.

\(^{107}\) Coffil & Willson Jr, above note 92, at 1110-1111.

\(^{108}\) CCCTB WP60, paragraph 69.
For example, the EC has suggested that “for reasons of practicality and simplicity”, the “asset” factor in the formula should exclude the following items:\footnote{Ibid, paragraph 30.}

(i) trading stock;
(ii) financial assets; and
(iii) intangible assets.

The EC argued that despite “a very important component of assets for certain sectors (e.g. trading companies)”, trading stock should be excluded “because inventory could be rather mobile and therefore ... prone to manipulation”.\footnote{Ibid, paragraph 31.}

The EC similarly tried to justify the exclusion of financial assets based on anti-avoidance grounds, though that does not seem to be a concern for financial institutions (emphasis added):\footnote{Ibid, paragraph 32.}

... due to the mobility and high value of financial assets they could easily be used for factor ... shifting purposes. An exception for financial institutions could be envisaged as financial assets represent the main income generating part of the asset factor for those institutions.

It is not clear why the “main income generating asset” justification is not equally applicable to trading stock for trading companies.

The EC also argued that intangible assets should be excluded because (emphasis added):\footnote{Ibid, paragraph 30.}
First, it is sometimes very difficult to value ... Second, even if a solution to their valuation was found, some uncertainties on their location would still remain ... Third, intangible assets are very mobile and could be used as a tax-planning tool ...

It is clear that the proposed exclusion of intangible assets is controversial. The EC acknowledged that “some experts in the [CCCTB Working Group] have voiced their concern that in case intangibles were not taken into account, an important income-generating factor would be disregarded, thus leading to a misattribution of tax base” (emphasis added). In summary, the exclusion of the above items from the “asset” factor may be justified on pragmatic grounds. However, their exclusion contradicts the underlying theory of the multilateral FA model, rendering the allocation result arbitrary.

The CCCTB experience suggests that anti-avoidance concerns feature dominantly in the “many long debates” over the factors in the formula, and ironically, “in the end, [the EC] realised that [it] had no better solution ... than do those who work under the transfer pricing” (emphasis added).  

(6) Valuation of factors: theory vs reality
Market value is in general regarded as the theoretically correct valuation method for an FA system. However, as “a practical expedient,
nevertheless, most of the U.S. states use original cost as a proxy for value" (emphasis added).\textsuperscript{116} In contrast, the EC proposed to value assets in terms of “tax written down values” though recognising that market value is “the theoretically correct value”.\textsuperscript{117} The theoretically correct valuation is rejected due to “the difficulties and compliance costs related to measuring it”.\textsuperscript{118}

(7) “No-where sales”: interaction between the two doctrines

“No-where sales” is an issue arising from the interaction between the enterprise doctrine and the separate entity doctrine and is a good illustration of the arbitrariness of the multilateral FA model. “No-where sales” occurs if the sale is located in a country either (a) participating in the FA regime, but the group does not have a subsidiary or PE in the country; or (b) not participating in the FA regime.

For the first scenario, the issue is whether the country should have taxing right on its share of the tax base. If so, who should be the taxpayer? If not, where should the location of that sale be? Under the enterprise doctrine, the country should still have the taxing right on its share of the group’s tax base as long as the group has sales, payroll or asset factors located there. This is the recommendation of the U.S. experts to the EC.\textsuperscript{119} However, the EC was reluctant to adopt this recommendation, as it would represent a drastic change.

\textsuperscript{116} Ibid, at 940. McIntyre did not elaborate on the problems of adopting historical cost, which would produce “distortion [which would be] particularly significant ... in inflationary economy”: Brown, above note 55, at 765.

\textsuperscript{117} CCCTB WP60, paragraph 36. A related issue is whether the tax written down value at the year-end should be used, or an average over a year. The EC is still seeking comments on this issue: ibid, paragraph 38. The year-end value is simpler, but more arbitrary, as it does not reflect the income-generating capacity over the year.

\textsuperscript{118} Ibid, paragraph 36. For more arguments between the choice of valuation (including historical costs), see for example, CCCTB WP56, paragraph 22.

\textsuperscript{119} CCCTB WP64, paragraph 53. The main concern of the U.S. experts was that requiring a subsidiary or PE before tax base could be allocated to a country would lead to “the risk for market States of losing a substantial part of the tax base” (emphasis added): ibid.
from the current rules of taxing group profits and would be inconsistent with the OECD principles.\textsuperscript{120}

If it is accepted that the sales would not be located in that country, the question becomes where the location should be. There are basically three possibilities:\textsuperscript{121}

(i) throw-out rule: that sale is ignored in the sales factor;
(ii) throw-back rule: that sale is deemed to be located in the country where the seller is located (i.e. revert back to "sales by origin" basis); or
(iii) spread throw-back rule: that sale is shared by group members according to their payroll and asset factors.

The EC rejected the first two alternatives – which are in use by states in the U.S. in practice – "due to the potentially incoherent results to which those solutions could lead".\textsuperscript{122}

Detailed discussion of the "no-where sales" issue is beyond the scope of this chapter.\textsuperscript{123} It is sufficient for the present purpose to recognise that each of the three alternative policy options may be appropriate in different situations, depending on the particular circumstances of a group. Applying a generic mechanical rule to deal with all "no-where sales" issue is bound to produce inappropriate and arbitrary results.

\textsuperscript{120} CCCTB WP60, paragraph 61. The issue is complicated by the problems of determining the location of a sale, which is discussed in more detail below.

\textsuperscript{121} For an illustrated example of the alternative policy options, see Appendix C Section C.1.8. For discussions of the throw-back and throw-out rules in the U.S. States, see McIntyre, above note 16, at 941-944.

\textsuperscript{122} CCCTB WP60, paragraph 59.

\textsuperscript{123} For more discussion of this issue with a numeric example, see Appendix C Section C.1.8.
In summary, the FA method is inherently arbitrary and thus would likely produce unfair allocation of tax base. Anti-avoidance concerns dictate that the actual FA design would deviate from the fundamental principles. For instance, as factors in the allocation formula are open to taxpayer manipulation, their definitions and scopes have to be compromised thus rendering them less effective as income apportionment criteria.\footnote{Roin, above note 16, at 204.} In fact, the EC acknowledged, amid a heated debate on the possibility of adjustments to correct differentials in wage levels across EU countries, that the allocation formula “does not aim at identifying a \textit{hypothetical scientific truth} but at achieving a \textit{‘rough’ (although fair) approximation} ...” (emphasis added).\footnote{CCCTB WP56, paragraph 17.} It is clear that the EC is well aware that the FA method is just a “rough estimate” approach. But it is not clear as to why it believes that such an arbitrary allocation could still be “fair”.\footnote{As discussed in the context of “political resistance” above, it is clear that some member states are “calling for some adjustment to take into account the lower average level of wages in those countries and avoid an \textit{unfair} apportionment” (emphasis added): ibid, paragraph 16.}

The OECD prefers transactional profits methods over the FA method, as the former is based on “careful analysis of the particular facts and circumstances \[of a specific multinational corporate group\] ... thus [avoiding] the \textit{globally pre-determined and mechanistic nature} of global formulary apportionment methods” (emphasis added).\footnote{OECD, \textit{Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations} (2010) (available at www.oecd.org), paragraph 1.18.} The OECD has even suggested that “the distortions produced by formulary apportionment are likely to be greater [than
the present system] ... and so such a system is likely to be less fair” (emphasis added). 128

11.5.3 Complexity

Simplicity has been suggested as one of the reasons for introducing the multilateral FA model. However, the CCCTB experience suggests otherwise. The complexity of the proposed CCCTB regime is ironically highlighted in a taxation paper commissioned by the EC itself. 129 After distributing the paper to Member States as preparation for discussion, the EC had to play down the complexity highlighted in the paper (emphasis added): 130

The ... paper ... focuses mainly on the complexities and challenges linked to the various apportionment mechanism systems and may give the impression to the readers that the sharing out mechanism is very complicated and burdensome. However, it does not include a comparison between the apportionment mechanism and the current system of separate accounting ... with arm’s length pricing ... and therefore does not examine the disadvantages of the [current system].

The complexity of the CCCTB regime arises primarily from the following sources:

129 Ana Agundez-Garcia, “The Delineation and Apportionment of an EU Consolidated Tax Base for Multi-Jurisdictional Corporate Income Taxation: A Review of Issues and Options” (European Commission Taxation Paper, 2006, EC, Luxembourg). For instance, in the conclusion of the paper, the author stated that “[the] result seems to be that both the delineation and apportionment of an EU [common tax base] continuously encounters important technical ... difficulties” (emphasis added): ibid, p.85. The complexity of the FA method under the proposed CCCTB contradicts the EC’s basic principle of the sharing mechanism, namely it should be “as simple as possible to apply for taxpayers and tax administrations ...”: CCCTB WP60, paragraph 8.
130 CCCTB WP47, paragraph 3.
(1) number of taxpayers affected;
(2) definition of a "group";
(3) definition of "tax base";
(4) apportionment formula;
(5) transitions and interactions between the two doctrines; and
(6) international issues.

Some of these issues are summarised below.\textsuperscript{131}

\textbf{11.5.3.1 Number of taxpayers affected}

The existing transfer pricing problems affect only group members with cross-border transactions. Companies with no or minimal cross-border transactions would not be substantially affected by the problems. However, under the multilateral FA model, every group member of a multinational enterprise — including those without cross-border transactions — would by default be examined and all their activities would be subject to scrutiny. It has been predicted that "the universe of the transactions that will have to be examined [under the FA method] will increase dramatically. One always must be careful that the cure is not worse than the disease".\textsuperscript{132}

\textbf{11.5.3.2 Definition of a "group"}

Even proponents of the model concede that it is difficult to define what a group should be under the model.\textsuperscript{133} The task is made more difficult as

\textsuperscript{131} For more detailed discussion of the issues, see Appendix C Section C.2.

\textsuperscript{132} Coffill & Willson Jr, above note 92, at 1116-1117.

\textsuperscript{133} See for example Avi-Yonah & Clausing, above note 16, at 23-24; Li, above note 16, at 844. The issues related to the definition of a group under domestic consolidation regimes are discussed in detail in Chapters 7 and 8.
multinational groups will “attempt to include or exclude some [entities] from a common enterprise to minimize its taxes”. 134 Issues include.135

(1) **Sandwich structure:**
A “sandwich structure” refers to a group of resident companies with a non-resident intermediary holding company. The issue is whether the non-resident intermediary holding company breaks the ownership chain. The current position of the EC is that such structure does not break the ownership chain. The rationale for the EC position is that “otherwise taxpayers could split groups into multiple groups”, 136 though it does not explain why it is not acceptable for a corporate group to form multiple consolidated groups. 137 The EC position may be explained by the eagerness of the EC to make the CCCTB regime as attractive to businesses as possible. 138 The EC is willing to take this position even though it is aware of the potential “double dip” issues 139 and the possible problems to audit these structures. 140 Specific anti-

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134 McIntyre, above note 16, at 935.

135 For discussion of two other issues of the definition of a group, namely “eligible entities to join the CCCTB regime” and “unitary vs multiple businesses”, see Appendix C Section C.2.2.3 respectively.

136 CCCTB WP57, paragraph 87.

137 The policy contrasts with the Australian consolidation regime, under which foreign owned groups (known as MEC groups) may form multiple consolidated groups, even though all companies involved are ultimately owned by the same non-resident parent company: Division 719 ITAA1997. Interestingly, the Australian model is inconsistent in the sense that corporate groups owned by resident parent company do not enjoy this flexibility. In particular, a non-resident intermediary holding company in such domestic groups would break the ownership chain, and resident companies under this non-resident company are not eligible to consolidate with the parent company: s.703-15(2) and 703-45 ITAA1997. This restriction represents a back flip of the original policy (which allowed sandwich structure without breaking the chain), just one year after the introduction of the consolidation regime in Australia. The experience suggests that this issue is complicated and controversial.

138 European Commission, “An overview of the main issues that emerged at the third meeting of the subgroup on group taxation” (CCCTB\WP\053, CCCTB WG, 2007) (“CCCTB WP53”), paragraph 16.

139 For more discussions of the issues, see European Commission, “Anti-abuse rules” (CCCTB\WP\065, CCCTB WG, 2008) (“CCCTB WP65”), paragraphs 40-43. The double dip
avoidance provisions would be required to deal with the issues, thus making the CCCTB regime more complex.\textsuperscript{141} It appears that the EC position is controversial, as a “new round of discussion on this topic did not manage to remove the concerns and reluctance of some experts [from Member States]”.\textsuperscript{142}

\textbf{(2) Ownership threshold:}

One important issue in the definition of a group is the ownership threshold. It is controversial whether the threshold should be set at 50 per cent, 75 per cent, 100 per cent or some other percentage. The issue has been the subject of “intense debate” in the EC.\textsuperscript{143}

The EC proposes a threshold of 75 per cent under the CCCTB regime. It openly admitted that the 75 per cent “was actually a kind of compromise between all thresholds utilised in the EU (between 50\% and 95\% and above 75\% in most [Member States])” (emphasis added).\textsuperscript{144} In essence, the threshold issue involves a trade off between anti-avoidance concerns and

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\textsuperscript{140} European Commission, “An overview of the main issues that emerged at the second meeting of the subgroup on group taxation” (CCCTB\ WP048, CCCTB WG, 2006) (“CCCTB WP48”), paragraph 8.

\textsuperscript{141} For alternative anti-avoidance rules targeting the abuses, see ibid, paragraph 42.

\textsuperscript{142} CCCTB WP53, paragraph 16.

\textsuperscript{143} For a description of the “intense debate” about the threshold and the pros and cons of having a threshold lower than 75 per cent, see CCCTB WP64, paragraphs 19-22.

\textsuperscript{144} Ibid, paragraph 19.
attractiveness of the regime (i.e. as an incentive measure). Not surprisingly, the position was attacked, as “determining the threshold only by an average is certainly not the base for good policy”.146

11.5.3.3 Definition of “tax base”
Definition of tax base presents another source of complexity.147 A key question is whether the tax base of a group should be defined under a new set of rules specifically designed for the multilateral FA model, or should be determined under the tax rules of the country where the parent company resides.

Under the multilateral FA model, a country can get its share of tax revenue in two ways: (1) sharing a group’s common tax base; and (2) imposing other taxes directly on group companies resident in the country.148 Conflict of interest arises in the latter scenario: if the other taxes are deductible in the calculation of the common tax base, they would reduce the size of the “pie” for sharing with other countries.

This issue was debated in depth in the CCCTB Working Group.149 Solutions suggested include: (1) no deduction for such taxes; or (2) deduction allowed

145 The EC believed that a lower threshold (namely 50%), together with the all-in rule, was an effective anti-avoidance policy against “cherry-picking” group entities to join consolidation. However, some member states disagreed and “considered consolidation as an incentive rather than as an anti-abuse measure”, and thus suggested a high threshold (up to 100%): CCCTB WP59, paragraph 36.
146 CCCTB WP64, paragraph 19. For more discussion of the ownership threshold issue, see Appendix C Section 2.2.2.
147 See for example Schönh, above note 83, at 1074-1076; Li, above note 16, at 846; Avi-Yonah & Clausing, above note 16, at 29-31; Martens-Weiner, above note 16, Chapter 5. See Appendix C Section 2.2.3 for a more detailed discussion of the issues with respect to the definition of “tax base”.
148 For instance, taxes may be charged on production factors such as payroll or property.
149 CCCTB WP46, paragraphs 10 & 11.
only after apportionment of tax base.\textsuperscript{150} No specific further discussions on this issue seemed to have taken place, but the current position of the EC appears to be that there is no specific disallowance of such taxes.\textsuperscript{151}

Some proponents of the FA method may suggest that the worldwide convergence of IFRS would reduce complexity of the definition of a common tax base. However, IFRS is at best just a starting point. For instance, the EC has stressed that “it is not possible to make a formal link between the [tax] base and ... IFRS”.\textsuperscript{152} The reason is that IFRS is not universally adopted in the EU or for all companies.\textsuperscript{153} This means that under the CCCTB regime, most companies would have to start with accounts prepared under the national accounting rules, and then make necessary adjustments in accordance with the CCCTB rules to arrive at the common tax base.\textsuperscript{154} However, concerns were raised that the need for 27 different “bridges” between the national accounting rules and the CCCTB rules “would not bring about the simplification ... which it is supposed to”.\textsuperscript{155}

\textbf{11.5.3.4 Apportionment formula}\textsuperscript{156}

The design of the apportionment formula is possibly the most difficult issue in a multilateral FA model.\textsuperscript{157} It is affected by a matrix of economic, political

\begin{itemize}
\item \textsuperscript{150} Ibid, paragraph 11.
\item \textsuperscript{151} CCCTB WP57, paragraphs 24 & 25.
\item \textsuperscript{152} Ibid, paragraph 9.
\item \textsuperscript{153} For example, many Member States do not permit the use of IFRS for individual company accounts and not all IFRS are considered suitable for tax purposes: ibid, paragraph 9.
\item \textsuperscript{154} Ibid.
\item \textsuperscript{155} CCCTB WP59, paragraph 20.
\item \textsuperscript{156} For a more detailed discussion of this complex issue, see Appendix C Section C.2.4.
\item \textsuperscript{157} For a good discussion of the problems, see Schön, above note 83, at 1078-1079. See also for example Martens-Weiner, above note 16, Chapter 4; McIntyre, above note 16, at 940-941.
\end{itemize}
and administrative considerations.\textsuperscript{158} It involves complex and highly controversial issues, including the number of factors in the formula, choice of factors, definition of each factor, and weighting attached to each factor.

(1) Scope of the formula
It is widely accepted that it is not possible to have only one formula applying to all industries.\textsuperscript{159} Experience in the U.S. and Canada suggests that the model would most likely require many industry-specific formulae, thus increasing complexity.\textsuperscript{160}

(2) Number of factors in the formula:
A fundamental question is how many factors should be included in the formula. Theoretically, it should include all income generating factors of a corporate group. However, the precision of that approach must be sacrificed for a single common formula.

\textsuperscript{158} The OECD recognises a number of issues about the design and implementation of the formula, including exchange rates movements, “intolerable” compliance costs and valuation of factors: OECD, \textit{Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations} (2001, OECD, Paris), paragraphs 3.68-3.71. The issues remain the same at present: OECD, \textit{Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations} (2010, OECD, Paris), paragraphs 1.25-1.32. For a more detailed discussion on the issues, see Martens-Weiner, ibid, Chapter 4. In particular, intangible assets are problematic as they are “highly mobile” and at the same time represent generally significant values and contributions to the overall profitability of the group. It can be difficult to decide whether to include such assets in the formula at all, and if so, how to minimise tax avoidance opportunities. For more discussion on the formula design issue, see James W Wetzler, “Company Tax Reform in the European Union: Guidance from the United States and Canada on Implementing Formulary Apportionment in the EU (Book Review)” (2006) 59(2) \textit{National Tax Journal} 397, at 399.

\textsuperscript{159} This is the position of all US experts that participated in one of the EC meetings on CCCTB: CCCTB WP64, paragraph 46. Industries for which specific formulae have been developed include financial institutions, transportation, communications, oil and gas pipelines and professional sports: McDaniels, above note 53, at 710-711.

\textsuperscript{160} Martens-Weiner, above note 16, at 55-57.
Proponents of the multilateral FA method have suggested different number of factors in the formula. Some have suggested just one factor. Many have suggested three factors – payroll, asset and sales – which are the most common factors adopted in existing FA method used in the U.S. States. Some simply suggested that “[much] more sophisticated factors [than the three factors] need to be developed for today’s multinationals”.

The current EC position is that it prefers at least three factors. It believes that a multiple-factor formula would “create a robust, i.e. not volatile apportionment mechanism ... [as] the relocation of one unit of one of these factors would shift less than one unit of the tax base” (emphasis added).

(3) Choice of factors:
The EC has considered three alternative choices of factors – macro-factors (for example, GDP of a country); value added; and traditional micro-factors such as sales and payroll – and finds that all of them are problematic.

The traditional micro-based approach is the current preferred choice of the EC. However, the EC’s position is ambiguous, as it states that it intends “to

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161 For example, some suggested using “sales” as the sole apportionment factor: Avi-Yonah & Clausing, above note 16.

162 See for example: McIntyre, above note 16, at 940-941. The EU experts in general accept that payroll and asset are important income-generating factors that should be included in the apportionment formula, but inclusion of the sales factor was much more controversial: for example, see CCCTB WP52, paragraphs 22, 31 & 39.

163 McDaniel, above note 53, at 708.

164 CCCTB WP60, paragraph 10.

165 Ibid, paragraph 10. The other reason given by the EC is that a multiple-factor formula would facilitate negotiation and agreement among countries on the definition and weighting of the factors: ibid.

166 CCCTB WP59, paragraph 9-19.

167 CCCTB WP60, paragraph 9. For detailed discussions of the three alternatives and the reasons for the EC’s preference, see for example CCCTB WP52.
put the macro-based approach and the [value added approach] in a ‘stand by’ position – without definitely excluding these possibilities as a mechanism to share the consolidated tax base”(emphasis added). In fact, the EC has left open the possibility of a “hybrid” formula, which combines both macro and micro factors. For example, “introducing a macro-factor into a micro-based apportionment could combine the advantage of the fairer sharing attained by micro-factors ... with some added stability to the mechanism ...”. However, a “hybrid” most likely would compound the problems and complexity of the FA method.

(4) Definition of each factor:
Some of the complexity involved in the definition of each of the allocation factors (namely, sales, payroll and asset) is summarised below.

Sales factor
The sales factor is perhaps the most controversial among the three typical factors. Issues include:

• Should it be a factor at all? The EC supports the inclusion of the sales factor primarily for two reasons. First, the sales factor is an income-generating factor on the demand side, as “sales could be seen as a reasonable apportioning factor since companies make profits only insofar as their output is sold”. Second, the EC relies on the experience in the U.S. and Canada where “sales are currently used in

168 CCCTB WP52, at 11.
169 Ibid, paragraph 48.
170 CCCTB WP56, paragraph 25.
171 CCCTB WP60, paragraph 43.
172 Ibid, paragraph 43. This position was strongly supported by U.S. experts who posed this challenge: “try to make profits if you cannot sell anything”: CCCTB WP64, paragraph 48.
formulary apportionment systems of the [two countries] and no plans seem to exist for changing this fact.\textsuperscript{173}

Many experts in the EC disagreed with the "demand side income-generating factor" argument. They argued that sales should not be a factor at all. On one hand, a "sales by origin"\textsuperscript{174} factor would simply duplicate the other two factors, namely payroll and asset.\textsuperscript{175} On the other hand, a "sales by destination" factor in the apportionment formula would be an inconsistent concept to the current international tax regime, under which in general the source country does not have a taxing right on the sales profits unless a taxpayer has a permanent establishment in the country.

- Sales by origin or destination?

If it is accepted that "sales" should be a factor in the allocation formula, a difficult question that follows is whether the location of the sales factor should be at origin or destination. The choice would have very significant implications on the share of tax base by each jurisdiction.

\textsuperscript{173} CCCTB WP60, paragraph 43. In contrast to many EU experts, experts from the U.S. who were invited to advise the EC were clearly in support of the inclusion of the sales factor: CCCTB WP64, paragraph 46. Another reason put forward by the U.S. experts in support of a sales factor is that "it is more difficult for companies to manipulate their markets": ibid. The emphasis on the sales factor in the U.S. is due to two main reasons: (1) implicit tax on the factors: the factor choice has significant effect on the actual economic activities in a state, which understandably would be reluctant to place more emphasis on the asset and payroll factors; and (2) anti-avoidance concern: it did not take long for the U.S. states to realise that factors of production are more mobile than markets: Roin, above note 16, at 203.

\textsuperscript{174} A "sales by origin" factor implies that tax base would be allocated to the country of origin of the sales. Alternatively, a sales factor may be by destination, meaning that the tax base would be allocated to the source country. Even among supporters of including the sales factor, the two alternatives also caused intense debates in the EC, and will be discussed in more detail below. For the present purpose, it should be noted that the current preference of the EC is the "sales by destination" factor.

\textsuperscript{175} CCCTB WP52, paragraph 39.
Both alternatives have problems and the choice between them is very controversial. The issue is also political, as sales by destination tends to favour large countries, as “small countries with a limited demand ... would be worse off compared to large countries with a significant internal demand ...”. Another problem with a “sales by destination” factor is that it is unlikely to be acceptable to “natural resource-exporting” countries. These countries currently have in general the taxing rights over their natural resources, and it is difficult to contemplate why they would be willing to give up those rights.

Moreover, both alternatives are subject to manipulation, which is a major concern for the EC.

- Scope

The EC suggested that passive income (such as dividends, interest and royalties, unless it represents ordinary business income) should be excluded

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176 For instance, the EC currently prefers sales by destination, but that position clearly is not shared by all: see for example the debate among EC experts on this issue in: ibid, paragraphs 41-43. For the debate primarily between the U.S. and EU experts on this issue, CCCTB WP64, paragraphs 47-58. It appears that in general EU experts were not in favour of sales by destination. For instance, it was reported that “no [EU] expert spoke in favour of sales by destination”: CCCTB WP59, paragraph 13.

177 CCCTB WP52, paragraph 43.

178 For example, in the EU, it was reported that “at least 90% of the profit [from natural resources] is [taxed] on a source basis”: CCCTB WP64, paragraph 57.

179 On this point, it is interesting to observe that the U.S. states which continue to place emphasis on payroll and asset factors “tend to be natural resource rich states, which do not have to worry about business relocations”: Roin, above note 16, at 204.

180 For example, sales by origin “could be manipulated ... since group companies could simply choose the place of their establishment [for shipment to their customers] and therefore the origin of sales”: CCCTB WP64, paragraph 58. Sales by destination may be manipulated by routing the sales through an independent distributor in a particular country, while sales by origin may be manipulated by choosing the group company that makes the sales: ibid, paragraphs 50 & 58. See also CCCTB WP52, paragraph 45.
from the sales factor.\textsuperscript{181} Passive income is excluded from the sales factor primarily as an anti-avoidance measure against "factor shifting"\textsuperscript{182}

In contrast, intra-group sales were suggested to be excluded from the tax base, but to be included in the sales factor.\textsuperscript{183} The EC position may be influenced by political concerns, as "the current tax base distribution within a group composed of, for example, a manufacturing company, a distribution company and a marketing company would be completely changed within a formulary system compared to the current situation" (emphasis added).\textsuperscript{184}

It is unclear if the argument is valid. First, the country in which the manufacturing company is located would receive allocation of tax base under the payroll and asset factors. Second, the inclusion of intra-group sales would create "factor-shifting" opportunities.

• Location
The EC suggested that the location of the sales factor should be determined on the destination basis, that is to the group member located in the country where the sales to third parties occur.\textsuperscript{185} The location rules can be complicated, especially for sales of intangibles. Possible alternative location rules – all of them have been proved to be difficult to apply in practice – include: (a) where the intangible is used; (b) where the intangible is created; and (c) where the

\textsuperscript{181} CCCTB WP60, paragraph 50.
\textsuperscript{182} Ibid, paragraph 51.
\textsuperscript{183} The EC originally appeared to prefer excluding intra-group sales from the factor, but seemed to have changed its mind: CCCTB WP56, paragraph 29.
\textsuperscript{184} CCCTB WP52, paragraph 40.
\textsuperscript{185} CCCTB WP60, paragraph 53. The existing VAT rules on the location where goods and services are deemed to have been supplied were suggested "as a starting point": ibid, paragraph 54.
“income producing activities” are performed. The EC appeared to be silent on this point, unless sales of intangibles are regarded as “extraordinary income” which is specifically excluded from the scope of the sales factor.

Location of sales is also prone to manipulation. While sales by origin may be manipulated by shifting the sales to third parties from one subsidiary to the other, sales by destination can also be manipulated by assigning a distributor in one country instead of another. Various measures were suggested to counter such manipulations, thus making the regime more complicated.

**Payroll factor**

Complexity with respect to the payroll factor includes:

- **Employee vs self-employed**

The payroll factor should theoretically represent the income-generating power of a group’s employees. In practice, it is difficult to distinguish between employees and the self-employed. The cross-border nature of CCCTB makes the issue more complex. For instance, countries may have different definitions and interpretation on the meaning of “employee”. The question is which country’s interpretation should prevail.

The current position of the EC is that “all personnel employed by a given entity should be covered ... The definition of an employee should be based on domestic legislation of the MS where the employee works and should mutually

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186 Brown, above note 55, at 766; and Wilkins & Gideon, above note 60, at 1264.
187 CCCTB WP60, paragraph 50.
188 CCCTB WP56, paragraph 34.
be recognised among MSs…” (emphasis added).\(^{189}\) The lack of a consistent definition of “employee” among Member States can create complex issues.\(^{190}\)

The issue also gives rise to avoidance opportunity. The payroll factor may be manipulated by making “use of ‘formally’ self-employed workers … who in reality operate as dependent employees …”.\(^{191}\)

- **Outsourced services**

It is controversial whether the payroll factor should include outsourced services. Some EU experts argued that they should be included for the following reasons: (1) similar income-generating factor;\(^{192}\) (2) fairness;\(^{193}\) and (3) avoidance opportunity. Other experts argued that outsourced services should be included only if they are related to the “core business” of a company.\(^{194}\) The EC position is to exclude outsourced services from the payroll services, except for outsourcing between consolidated group members.\(^{195}\)

- **Location**

Location of the payroll factor is prone to manipulation. For instance, the location of the payroll factor may be shifted to a particular country (for

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\(^{189}\) CCCTB WP60, paragraph 22.

\(^{190}\) The EC recognised that “it would be extremely burdensome, and probably impossible … to harmonise national legislation in order to reach a common definition of an employee”: CCCTB WP56, paragraph 8.

\(^{191}\) CCCTB WP52, paragraph 25.

\(^{192}\) CCCTB WP56, paragraph 10.

\(^{193}\) Ibid, paragraph 10.

\(^{194}\) Ibid, paragraph 11. For more discussion on this avoidance opportunity, see Roin, above note 16, at 205.

\(^{195}\) CCCTB WP60, paragraph 24.
example, a low tax country) by: (i) outsourcing of labour;¹⁹⁶ and (ii) secondment.¹⁹⁷ In response to the potential factor-shifting, the EC suggested that the location of the payroll factor should be “the place where the employees provide their services”.¹⁹⁸ This position makes the FA regime more complicated.

• Valuation

The key valuation issue of the payroll factor is whether the amount of employee remuneration¹⁹⁹ is sufficient by itself. This begs the question of whether it should be adjusted by say the different levels of wages in different jurisdictions,²⁰⁰ and if so, how it should be adjusted.

Some EC experts argued for adjustment “to take into account the lower average level of wages in some MS to avoid an unfair apportionment” (emphasis added).²⁰¹ This issue is political, and not surprisingly, some member states objected to the suggested adjustments. In particular, some argued that as “high wage countries are high price countries, the price of the public services the administration has to provide is higher. Thus a formula including headcount might unfairly reduce their share of the consolidated profit…” (emphasis added).²⁰²

¹⁹⁶ CCCTB WP52, paragraph 24.
¹⁹⁸ CCCTB WP60, paragraphs 24 & 27.
¹⁹⁹ The EC suggested that the figure to take into account should be “the amount of remuneration that is taken into account as a deductible expense for the purpose of calculating the tax base, including fringe benefits, social contributions, stock options, etc”: ibid, paragraph 25.
²⁰⁰ For arguments for and against such adjustment, see for example CCCTB WP52, paragraphs 28-30; CCCTB WP59, paragraphs 53-54; and CCCTB WP47, paragraph 15.
²⁰¹ CCCTB WP60, paragraph 26.
²⁰² CCCTB WP64, paragraph 60.
The EC's position is somewhat ambiguous. On the one hand, it refused to adopt such an adjustment for the different levels of wages. On the other hand, it suggested inclusion of the "number of employees" – in addition to the amount of remuneration – in the payroll factor and recognised that this inclusion "has to some extent a similar effect".

Asset factor

The asset factor is also very complex. Some of the major issues include:

- Intangibles

Intangibles raise significant issues in the asset factor. Theoretically, intangibles should be included in the asset factor, as they are "nowadays one of the potentially most important profit-generating factors". However, they present serious valuation and location issues. For instance, if intangibles are included in the asset factor, they would "raise exactly the same valuation problems that have been so difficult to deal with in the context of arm's length pricing" (emphasis added). Furthermore, being very mobile, they are very prone to manipulation.

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203 For the allocation formula suggested by the EC, see CCCTB WP60, paragraph 12.

204 Ibid, paragraph 26.

205 CCCTB WP47, paragraph 16. For instance, it has been estimated that intangibles such as product designs, know how, branding, etc. accounted for approximately 70 per cent of the value of the top 150 US companies: Roin, above note 16, at 206.

206 Intangibles can be very difficult to value, especially self-generated intangible assets. Location of intangibles can also be a challenge, especially when intangibles are created and/or used by the entire group: CCCTB WP60, paragraph 33.

207 Brown, above note 55, at 765. A similar observation was made by Coffill and Willson: Coffill & Willson Jr, 92, at 1108.
For these practical reasons, intangibles are typically excluded from the asset factor in the FA regimes of the states in the U.S.\textsuperscript{208} The EC also suggested excluding intangibles from the asset factor due to these reasons.\textsuperscript{209} This is despite the understanding that "an important income-generating factor would be disregarded, thus leading to a misattribution of tax base" (emphasis added).\textsuperscript{210}

The EC tried to justify the exclusion by arguing that "intangible assets ... are already (partly) included indirectly in the apportionment formula via ... other factors: salaries of researchers ...; assets used for creating intangibles ..." (emphasis added).\textsuperscript{211} The argument has at least two problems. First, even the EC conceded that even if its argument stands, part of the income-generating power of intangibles is still not presented in the formula. Second, it is doubtful if the argument is valid. For instance, an intangible may be created 20 years ago in Country A, but the current research staff and equipment is located in Country B. Using the current payroll and asset factors would produce inappropriate allocation with respect to the intangible.

• Location
The fundamental question of the location of the asset factor is whether it should be located in the country where the owner is, where it is used, or

\textsuperscript{208} McIntyre, above note 16, at 922. The U.S. experts advising the EC also suggested that intangibles should be excluded from the asset factor: CCCTB WP64, paragraphs 63 & 64.

\textsuperscript{209} CCCTB WP60, paragraph 30.

\textsuperscript{210} Ibid, paragraph 34. Some had suggested other factors to capture the income-generating power of intangibles, for example, cost of research and development expenditures: McDaniel, above note 53, at 723. However, those factors did not attract much attention or serious consideration, and thus are not discussed in detail.

\textsuperscript{211} CCCTB WP60, paragraph 34. US experts advising the EC made similar arguments: CCCTB WP64, paragraph 65.
determined by other criteria such as the location of the entity claiming tax
depreciation on the asset.

Some EU experts suggested that the asset factor should be located in the
country where tax depreciation on the asset is claimed under the CCCTB
regime.\textsuperscript{212} This appears to have the initial support of the EC.\textsuperscript{213} However, for
factor-shifting concerns, the current EC position is to “attribute the asset to the
entity which is effectively using the assets”.\textsuperscript{214} The rule is designed primarily
to prevent shifting the asset factor by intra-group leases of assets.

The leased asset issue is complex.\textsuperscript{215} The general location rule of effective use
has to be supplemented by a special location rule for leased assets between
lessor and lessee belonging to different consolidated groups.\textsuperscript{216} In particular,
in such cases, both lessor and lessee would recognise the leased asset in their
respective asset factors, but at different valuations.\textsuperscript{217} The EC admitted that
“these special rules could introduce some kind of complexities but are borne in
the necessity of preventing manipulations …”.\textsuperscript{218}

\textsuperscript{212} CCCTB WP52, paragraph 36.
\textsuperscript{213} CCCTB WP59, paragraph 10.
\textsuperscript{214} CCCTB WP60, paragraph 39.
\textsuperscript{215} For detail of the EC proposal on the location of leased assets, see Appendix C Section
C.2.4.2.4.3(b).
\textsuperscript{216} CCCTB WP60, paragraph 40.
\textsuperscript{217} Valuation issue of leased assets are discussed below. In essence, the economic owner of
the asset would value the asset under the normal valuation rule (namely, tax written down
value), while the other party would value the asset under a stipulated formula (namely, 8 times
the net annual rental): ibid, paragraph 40
\textsuperscript{218} Ibid, paragraph 65.
Valuation

It is widely accepted that in principle the asset factor should be at market value, which is a better measure of income-generating power of the asset than historical cost or tax written down value.\(^{219}\) However, while recognising it as the “ideal” approach, the EC rejected market value as it “would create too many complications without providing significant benefits”.\(^{220}\) Instead, the EC proposed to use “CCCTB tax written down value” as the valuation of the asset factor.\(^{221}\) The main argument for this option is that tax written down value “reflects most closely the market value of the asset”.\(^{222}\) It is doubtful if the two figures are always “close” in practice. Furthermore, the tax written down value is problematic. First, tax written down value bears no significant relationship with an asset’s income-generating power. Second, a fully depreciated asset would not be included in the asset factor but may still generate income for the group.

A related issue is whether to take the year-end tax written down value, or the average of the tax written down value for the year. This is basically a dilemma between simplicity and anti-avoidance concern. The year-end option is simple, but prone to manipulation.\(^{223}\) The avoidance opportunity is

\(^{219}\) For example, see McIntyre, above note 16, at 940; and CCCTB WP52, paragraph 33. Though having little relevance to the income-generating power of an asset, historical cost is the option adopted by most US states on pragmatic grounds: Wilkins & Gideon, above note 60, at 1264. Designers of the U.S. state FA regime admitted that historical cost was clearly arbitrary, but conceded that no valuation method would be “universally acceptable”: Coffill & Willson Jr, above note 92, at 1107

\(^{220}\) CCCTB WP52, paragraph 33.

\(^{221}\) Ibid, paragraph 33. The EC did not consider historical cost appropriate as “comparability issues may arise due to depreciation at different rates or acquisition at different times”: CCCTB WP47, paragraph 16.

\(^{222}\) CCCTB WP60, paragraph 36.

\(^{223}\) Ibid, paragraph 38.
particularly attractive, as under consolidation intra-group transfer of asset in general is tax free. The EC is still seeking expert advice on this issue.\textsuperscript{224}

(5) Weighting attached to each factor:
The allocation formula has been described as having no “principled basis to decide what weight should be given to a factor”.\textsuperscript{225} The EC also admits that this is a pure policy issue and regards a weighting formula as a solution that “seems to be tailored at balancing the interests of the manufacturing and the marketing states”\textsuperscript{(emphasis added).226} After reviewing the overseas experience of the weighting issue, it shied away from the controversy and basically put it into the “political discussion” basket.\textsuperscript{227}

In summary, the three factors raise serious problems and complexities when they are actually put into practice. The EC sums up the problems as follows (emphasis added):\textsuperscript{228}

\begin{quote}
The brief description of the three factors has shown that – in reality – there are no ‘ideal’ solutions and the choice concerning the definition, valuation and location of the factors and their inclusion ... in the formula requires a great deal of work.
\end{quote}

The challenges arising from the design of the allocation formula is well summarised by Schön (emphasis added).\textsuperscript{229}

\textsuperscript{224} Ibid.
\textsuperscript{225} Brown, above note 55, at 764.
\textsuperscript{226} CCCTB WP47, paragraph 18.
\textsuperscript{227} CCCTB WP60, paragraph 13.
\textsuperscript{228} CCCTB WP47, paragraph 20.
\textsuperscript{229} Schön, above note 83, at 1079.
... only a hybrid formula – such as one consisting in equal parts of wage bill, assets, and sales – should serve the purpose of formula apportionment. With the multiplication of attribution factors, the complexity of the system increases naturally as well as its susceptibility to mistakes and arguments … ultimately there can only be one decisive criterion for the choice of apportionment factors, that is, the political consensus between [jurisdictions].

11.5.3.5 Transitions and interactions between the two doctrines

The co-existence of two systems – the FA regime under the enterprise doctrine and the traditional tax regime under the separate entity doctrine – is a major source of complexity. The problems arise primarily in two ways:

(i) transitions between the two doctrines, for example, a company entering a consolidated group, or leaving a group; and

(ii) interactions between the two doctrines, for example, interaction of a consolidated group with other entities outside the consolidation regime.

As most of these issues are discussed in detail in the context of domestic consolidation in the preceding chapters, they are not analysed again here. The following paragraphs focus on some examples of the issues arising particularly in a multilateral regime.

1) Pre-consolidation assets

If a consolidated group disposes of an asset that is owned by a subsidiary before the latter joins the group, the question is who should be the taxpayer for the gain. It appears that this issue falls into the “too hard” basket for the EC,
which does not have a clear position on the issue yet.\textsuperscript{230} In particular, the EC simply stated that “transitional rules would be necessary for assets owned by group companies prior to the establishment of the consolidated group”. This issue is particularly sensitive for a multilateral FA regime such as the CCCTB proposal, as the taxing right on disposal gains of pre-consolidated assets may be allocated to different countries under alternative policies.\textsuperscript{231}

The EC’s tentative position is that in general the group should have the taxing right on the whole gain realised on an asset, although some of the gain accrued before consolidation.\textsuperscript{232} However, if the joining subsidiary comes from another CCCTB group, the two groups should share the gain by apportionment based on the periods of consolidation in each group.\textsuperscript{233} There are two problems with this policy. First, it would be complicated to comply with and administer in practice. Second, it is not clear why the apportionment rule should only apply in the case where the joining subsidiary comes from another consolidated group, but not in the case if a subsidiary by itself joins a group.

\textbf{(2) Pre-consolidation losses}

Most EC experts preferred the quarantine policy on pre-consolidation losses, as those losses were calculated under national tax rules which might be inconsistent with the CCCTB rules.\textsuperscript{234} A problematic issue follows. If the pre-consolidation losses are quarantined, the question is whether the subsidiary should be allowed to offset profits before or after apportionment of the group’s tax base.

\begin{itemize}
\item \textsuperscript{230} CCCTB WP57, footnote 32 at p.27.
\item \textsuperscript{231} See the Appendix C Section C.2.5.1.1 for detailed discussion of the alternative policies.
\item \textsuperscript{232} CCCTB WP53, paragraph 45.
\item \textsuperscript{233} Ibid, paragraph 46.
\item \textsuperscript{234} See for example CCCTB WP48, paragraph 10; CCCTB WP53, paragraph 22; and CCCTB WP57, paragraph 100.
\end{itemize}
The EC position is to apply pre-consolidation losses after apportionment of the group’s tax base.235 The main reason for such policy is simplicity, as it avoids calculation of taxable income of the subsidiary under national tax rules (instead of CCCTB rules) after consolidation.236

A potential problem with this policy is that the subsidiary may be allocated less taxable income under the FA model than the amount of taxable income calculated under national tax rules. In that case, the subsidiary may not have enough taxable income to fully utilise the pre-consolidation losses before the carry forward time limit expires (if such time limit exists under national tax law). Some were concerned that this might amount to discrimination against pre-consolidation losses.237

(3) Sale of shares vs assets
On the issue of unrealised gains on assets of a leaving subsidiary, the main concern of the EC is non-taxation. Under the current CCCTB proposal, sale of shares in a subsidiary would be exempt under participation exemption rules.238 In that case, the question is whether unrealised gain of underlying assets in the subsidiary should be taxed at the leaving time.

The EC experts are divided on the issue. Some prefer simplicity and argue for a blanket full participation exemption regardless of any underlying unrealised gains in the assets.239 The EC is not keen on this option, as it “would ...

235 CCCTB WP48, paragraph 10.
236 Ibid, paragraph 10.
237 CCCTB WP59, paragraphs 40-42.
238 It is proposed that gains of disposal of non-portfolio shareholdings by a group to entities both within and outside the bloc would be exempt: CCCTB WP57, paragraph 126.
239 CCCTB WP53, paragraph 43.
plainly be open to abuse as assets could easily be transferred into a company and the shares sold". Other EC experts are more concerned about avoidance opportunities and argue that the sale of shares should be deemed to be sale of the underlying assets. These experts argue that the policy is “consistent with the idea of treating a CCCTB group as if it were a single entity and the sale of an entity should be treated in the same way as the sale of an asset”. The EC also seems to be reluctant to adopt this policy and suggests that “some might consider ... that this [argument of deemed asset sale] pushes the logic too far” (emphasis added).

Having dismissed both suggestions as “extreme”, the EC proposes an “intermediate solution”: participation exemption would not apply to the extent that “assets were transferred to the departing company within the present or previous tax year [without valid commercial reasons] and their disposal would have triggered a gain ...”. Such an anti-avoidance provision would make the regime more complex.

(4) Optional regime
The CCCTB is most likely an optional regime, implying that all existing national tax systems will remain in operation. The introduction of an optional CCCTB regime in the EU increases the number of tax systems

240 CCCTB WP57, paragraph 109.
241 CCCTB WP53, paragraph 43.
242 Ibid. This “asset model” is adopted in the Australian consolidation regime, and has proved to be very complex and can produce arbitrary results.
243 CCCTB WP57, paragraph 108.
244 CCCTB WP57, paragraphs 108-109. Some experts even suggest that for anti-avoidance purpose the two-year period should be extended, particularly for intangible assets: CCCTB WP59, paragraph 43.
245 CCCTB WP57, paragraph 85.
working within the bloc.\textsuperscript{246} The operation of the multilateral FA regime, together with the simultaneous operations of 27 national tax systems, would likely increase rather than decrease complexity of the tax system in the bloc.\textsuperscript{247}

11.5.3.6 International issues
The proposed CCCTB regime faces similar challenges as the international tax regime of a country. Compromises often have to be made between anti-avoidance objectives and international competitiveness. For instance, the EC recognises that in the design of the international tax rules of the CCCTB regime, “there is an important balance to be struck ... between ... providing adequate protection for the tax base and ... providing a system that is competitive, workable and not overly complex”.\textsuperscript{248} Complexity arising from international transactions under the CCCTB regime includes the following:

- Foreign tax credit ("FTC")
- Withholding tax
- Participation exemption
- Conflict with tax treaties
- Concept of “resident”
- Profits of a PE
- Transfer pricing between a group and third parties

\textsuperscript{246} The situation would be more complicated if some Member States decide not to participate in the CCCTB regime all together, as they “may be afraid to give up too many powers and may be reluctant to confer executive powers on the Commission”: Kiekebeld & Smit, above note 85, at 322.

\textsuperscript{247} It has been argued that though the main argument for CCCTB is simplification, it is difficult to see how the “proposed arrangement of 27 national systems plus the CCCTB could achieve this”: Christiana HJI Panayi, “The Common Consolidated Corporate Tax Base - Issues for Member States Opting Out and Third Countries” (2008) 48(3) European Taxation 114, at 115.

\textsuperscript{248} CCCTB WP57, paragraph 131.
Detailed discussion of the issues is presented in Appendix C Section C.2.7. Some of the issues are summarised below.

(1) FTC
As foreign income would be allocated to jurisdictions under the apportionment formula, the corresponding FTC theoretically should be treated in the same way. The “FTC sharing out” policy is supported by the EC. It appears that the EC has not yet adopted a position on the issue. Instead, it simply stated that a “mechanism would be required for calculating the limit of the credit to be given by each MS”.

One problem arising from such treatment is the FTC limit imposed by each jurisdiction. It appears that the EC has not yet adopted a position on the issue. Instead, it simply stated that a “mechanism would be required for calculating the limit of the credit to be given by each MS”.

(2) Withholding tax
An intriguing issue with respect to the cross-border payment of passive income within a consolidated group is whether withholding tax should be levied. Under the enterprise doctrine, the whole group is treated as one single entity and intra-group transactions are in general ignored. Logically it follows that such payments should not be subject to withholding tax.

However, political reality again conflicts with the enterprise doctrine. Some EU countries appear to insist on exercising the right to levy withholding tax on

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249 This is the position of the EC, even though it recognises that much of foreign income might be exempt: ibid, paragraph 118.
250 Ibid, paragraph 120. Such “FTC sharing out” policy was also suggested by McDaniel in his proposal of a FA system for NAFTA: McDaniel, above note 53, footnote 137.
251 For an illustrated example of the issue, see Appendix C Section C.2.7.1.
252 CCCTB WP57, paragraph 120.
253 For a detailed discussion of the different scenario under which withholding tax may apply under the CCCTB regime, see CCCTB WP49, paragraphs 5-15.
such intra-group payments.\textsuperscript{254} The EC’s position is that withholding tax levied on such payment should be shared out among jurisdictions “according to an agreed mechanism”.\textsuperscript{255}

(3) Participation exemption
A common participation exemption regime has been proposed in the CCCTB regime.\textsuperscript{256} As an anti-avoidance measure, the EC suggests that the participation exemption be subject to a switch over to the credit method where the corporate tax rate in the source country is low.\textsuperscript{257} The threshold for switch over to credit method is suggested to be a tax rate “of not less than 40 per cent of the average statutory corporate tax rate applicable in MS ...”.\textsuperscript{258} That means the switchover rate would be 9.6 per cent, which is less than the current Irish rate.\textsuperscript{259} It appears that political concerns are important considerations in the design of the CCCTB regime.

(4) Conflict with tax treaties
Some of the CCCTB rules may conflict with double tax treaties.\textsuperscript{260} For example, the ten per cent participation exemption threshold suggested by the EC may conflict with existing tax treaties that provide for a lower threshold.\textsuperscript{261}

\textsuperscript{254} Ibid, paragraph 11.
\textsuperscript{255} Ibid, paragraph 11.
\textsuperscript{256} CCCTB WP57, paragraphs 119-126. It is suggested that the exemption would apply to “major shareholding”, meaning an interest of at least ten per cent of either capital or voting rights, which has been held for an uninterrupted period of at least 12 months: ibid, paragraph 125. The exemption would apply to both dividends and gains on disposals of the shareholdings: ibid, paragraph 126.
\textsuperscript{257} Ibid, paragraph 127.
\textsuperscript{258} CCCTB WP57, paragraph 128. Some EC experts suggested that a fixed rate (for example, 10%) would be preferable in practice to the average method: CCCTB WP64, paragraph 23.
\textsuperscript{259} Weiner, above note 114, at 16.
\textsuperscript{260} Conflicts of this kind are inevitable, especially given that “MS currently negotiate details in the individual treaties. Some MS do not even apply the same principles consistently in all their tax treaties ...”: CCCTB WP46, paragraph 18.
Chapter 11 Multilateral Consolidation: CCCTB Experience

The EC's suggested approach is to "allow MS in certain aspects to derogate temporarily from the [CCCTB] rules adopted in order to respect existing obligations ...". This may be a pragmatic approach to deal with the conflicts. However, such flexibility would contradict the primary objective of CCCTB, namely to provide a harmonised corporate tax environment in the common market.

11.5.4 Tax avoidance

The multilateral FA model fails to score better than the current international tax regime in terms of tax avoidance. For instance, it is likely that "many of the avoidance techniques honed by use under the current tax rules would be just as effective at defeating attempts to tax under [the FA] methods of taxation".

Experience of the CCCTB consultation process confirms this concern. The EC suggested that a "general anti-abuse rule could be established in the CCCTB to allow tax authorities to re-characterise wholly artificial transactions". In addition, it also suggested establishing several anti-abuse provisions, including:

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261 CCCTB WP57, paragraph 139.
262 Ibid, paragraph 139.
263 In an article focusing on evaluating possible gains to be generated through the elimination of avoidance possibilities by replacing the current international tax regime with the FA method, Roin concluded that such a drastic change would be unlikely to be justified: Roin, above note 16, at 174-175.
264 For a discussion of the avoidance potential with respect to the optionality of the CCCTB regime, see Appendix C Section C.3.
265 CCCTB WP65, paragraph 6.
266 Ibid, paragraph 10. For more detailed discussion of each of these rules, see ibid, paragraphs 12-45.
(a) thin capitalisation rules;
(b) switch over rules from participation exemption to credit method;
(c) CFC rules;
(d) rules to re-characterise sale of shares as sale of assets (as anti-abuse rules to protect the participation exemption regime);
(e) anti-double-dip rules for the sandwich situation; and
(f) rules targeting manipulation of factors.

Several observations can be made. First, the design of anti-abuse rules can be more difficult in a multilateral FA model as many countries are involved and agreements are essential for a common set of rules. For instance, not all EU countries have general anti-avoidance provision ("GAAP"). It is not clear if consensus can be reached to introduce a common GAAP in CCCTB. Second, the first four specific anti-abuse rules in the list above are not new. Transfer pricing issues would still trouble the CCCTB regime. The CCCTB regime is not better than the existing regimes in this respect. Third, the last two specific anti-abuse rules are new and specific to the CCCTB regime. From this perspective, the CCCTB regime is worse than the existing regimes, as it introduces new avoidance opportunities, thus requiring more specific anti-abuse regimes.

267 It can be equally difficult to reach a consensus on specific anti-abuse rules. For example, achieving a common definition of "related parties" among EU countries "is likely to be challenging": Panayi, above note 247, at 119. For the EC’s suggested definition, which is based on a widely-defined concept of "control", see CCCTB WP57, paragraph 78.

268 For instance, it would still be possible to shift income to group companies in tax havens from the bloc: McDaniel, above note 53, at 733. Transfer pricing can also be problematic within a consolidated group, for example, to split profits between different business lines in the same group if some businesses qualify for special allocation formulae. Furthermore, profits of a PE in the EU – which is included in the consolidated regime - of a non-EU head office would have to be determined under separate entity doctrine, thus inviting transfer pricing issues back into the CCCTB regime: CCCTB WP46, paragraph 29.
For instance, factor-shifting is one of the new avoidance opportunities created under an FA regime. The more mobile a factor is, the easier the factor may be shifted.\(^{269}\) If “sale by origin” is a factor in the allocation formula, it may be shifted easily within a group, as intra-group transactions are ignored under consolidation.\(^{270}\)

The coexistence of the dual system – namely the CCCTB regime and the normal national regimes – will lead to “considerable creative potential”.\(^{271}\) Multinational groups can shift income between the two systems. In general, there would be an incentive to shift income to countries adopting the model, as such income booked in those countries does not affect the allocation under the formula. In other words, countries adopting the model will appear as tax havens from the perspective of opt-out countries.\(^{272}\)

### 11.6 Conclusion

The multilateral FA model has been hailed as the solution for the existing transfer pricing regime for several decades. Major problems of transfer pricing, that the model is purported to resolve, can be summarised in the following diagram:

\(^{269}\) The EC believed that assets are the factor whose location is easiest to manipulate: CCCTB WP65, paragraph 45.

\(^{270}\) The EC suggested a possible anti-abuse rule under which intra-group transfers of assets would be ignored if “they are found to be made only with the intention of influencing the distribution of the [tax] base”: ibid, paragraph 45. Based on experience of similar anti-avoidance rules using the concept of “dominant purpose”, one can expect that in practice the anti-abuse rule would be difficult to implement and uncertain to both taxpayers and tax authorities.

\(^{271}\) Schön, above note 83, at 1077.

\(^{272}\) Avi-Yonah & Clausing, above note 16, at 26. Avi-Yonah and Clausing argue that this “tax haven” effect will force other countries to adopt the model: ibid.
However, the CCCTB experience confirms many concerns of the opponents to the multilateral FA model. A closer look at the model suggests that it is a similar animal with similar problems as the transfer pricing regime:
The primary driving force behind the CCCTB project is competitiveness and economic growth. However, the experience so far suggests that the multilateral FA model fails to exhibit clear superiority over the existing transfer pricing system in terms of complexity and arbitrariness. It is prone to abuse from not only existing avoidance practices, but also new opportunities created by the model itself. The CCCTB experience also highlights the formidable political obstacles that significantly hinder potential extension of the application of the enterprise doctrine to a multilateral level. It is doubtful if a drastic change from the current transfer pricing regime to the multilateral FA model can be justified or is achievable at all.
12.1 Introduction
This thesis provides the first comprehensive comparative analysis of the consolidation regimes in eight countries, namely, Australia, France, Italy, Japan, the Netherlands, New Zealand, Spain and the United States. The purposes of this thesis are twofold. First, alternative policy options for the key structural elements of a consolidation regime are identified, compared and evaluated. The comparative analysis assesses whether a stronger application of the enterprise doctrine in a consolidation regime necessarily implies a better regime on policy grounds. Second, the comparative analysis intends to search for a model consolidation regime, representing the best practice in respect of the key structural elements of the regime.

This chapter summarises the findings and the significance of the comparative analysis, explains the limitations of the research, and suggests future research areas. For detailed comparative analysis of the key structural elements, readers should refer to the respective chapters in Part Two of this thesis.

12.2. Summary of findings
12.2.1 Alternative policy options for key structural elements
The comparative study analyses the following ten key structural elements of a consolidation regime:
(1) The single entity concept;
(2) Consolidation of group results;
(3) Liability to tax;
(4) Election to consolidate;
(5) The “all in” rule;
(6) Definition of a group;
(7) Treatment of pre-consolidation losses;
(8) Treatment of consolidated group’s losses;
(9) Treatment of assets; and
(10) Treatment of intra-group shareholdings.

Only one of these ten key structural elements achieves a consensus among the eight countries: consolidation of group results. All the eight countries have full consolidation of taxable income and losses of group members, instead of proportional consolidation, even if a parent company holds less than 100 per cent interest in a subsidiary.

Five key structural elements exhibit convergence of policy options around the best practice:

(1) **The single entity concept:**
Six countries adopt the pooling system, which is the preferred policy option on simplicity grounds. The policy option implies not only simpler consolidation provisions, but also less complicated interactions between a consolidation regime and other parts of the income tax system.
(2) **Liability to tax:**
Six countries adopt the “joint liability” policy option, which is not only consistent with the enterprise doctrine but also enhances the policy objective of revenue collection.

(3) **Definition of a group:**
All the eight countries in general exclude non-resident companies from their consolidation regimes. In respect of the ownership threshold, five countries adopt the “substantially 100 per cent” policy option. Of the remaining three countries, at least the U.S. — which has an ownership threshold of 80 per cent — finds the presence of substantial minority interests problematic.

(4) **Treatment of pre-consolidation losses:**
Six countries adopt the quarantine policy which is also the preferred policy option on policy grounds, contrasting the alternative policies in Australia and Japan that are inferior primarily in terms of simplicity and competitiveness respectively.

(5) **Treatment of assets:**
Six countries adopt the rollover and recapture policy, which is also the preferred policy solution in terms of the policy objectives of simplicity and competitiveness.

The remaining four key structural elements exhibit divergent policy choices among the eight countries and do not have a clearly preferred option on policy grounds:
(1) *Election to consolidate:*
All the eight consolidation regimes are elective; none of them is mandatory. However, they diverge on whether the election is revocable or not. Three countries (the Netherlands, Spain and New Zealand) allow the election to be revoked, while four countries (France, Italy, Japan and the U.S.) do not. The remaining country Australia fails to have a consistent policy on the issue: the election is irrevocable for domestically-owned consolidated groups, but not so for foreign-owned consolidated groups. The divergent policy choices on this key structural element represent the difficult trade off between the policy objectives of anti-avoidance and competitiveness.

(2) *The “all in” rule:*
Four countries (France, Italy, the Netherlands and New Zealand) allow “cherry-picking” of subsidiaries to join a consolidated group, while three (Japan, Spain and the U.S.) impose the “all in” rule. Again, Australia fails to have a consistent policy between domestically-owned and foreign-owned groups. The divergent policies on this key structural element again reflect the delicate balance between the competing policy objectives of anti-avoidance and competitiveness.

(3) *Treatment of consolidated group’s losses:*
All the eight countries in general apply the enterprise doctrine during consolidation by treating group losses as those of a single company. However, the policies are less convergent on the treatment of group losses at leaving time, reflecting again the difficult balance between conflicting policy objectives. Three countries (Australia, France and New Zealand) adopt the “stay” policy, namely, the group losses stay with the consolidated group without allocation to a leaving subsidiary. In three other countries (Japan, Spain and the U.S.), a portion of the group losses is allocated to a leaving...
subsidiary. The allocation rules are often complex. The remaining two countries (Italy and the Netherlands) have a hybrid policy: while group losses in general stay with a consolidated group, they also allow the group to elect for allocation of the group losses to a leaving subsidiary. This hybrid policy provides more flexibility to corporate groups, thus achieving the policy objective of competitiveness. However, it increases complexity and is subject to abuse. The treatment of group losses at de-consolidation time exhibits similar divergent practice.

(4) Treatment of intra-group shareholdings:
The policies are diverse among the eight countries. With respect to intra-group share transfers during consolidation, two countries – namely Italy and the Netherlands – rely on the general exemption regime to exempt any gain or loss of the transfers. New Zealand achieves similar outcome due to the absence of a general regime to tax capital gains. Other four countries – namely France, Japan, Spain and the U.S. – adopt the rollover policy and recapture any deferred gain or loss when either the transferor or the transferee leaves the consolidated group. Australia, under its asset-based model, effectively deems that intra-group share transfer does not occur during consolidation, thus nullifying the issue.

With respect to the disposal of shares in a leaving subsidiary, four countries (France, Italy, the Netherlands and Spain) enjoy the benefits of an existing general participation exemption regime for corporate groups, thus rendering this key structural element a non-issue. New Zealand again enjoys a similar benefit due to the absence of a general taxation regime on capital gains. Each of the remaining three countries (Australia, Japan and the U.S.) however adopts a different policy option for this key structural element, suggesting that it is one of the most difficult elements to deal with.
Chapter 12 Conclusion

The comparative analysis reveals that many policy choices of a country on the key structural elements often represent a trade off between competing policy objectives of simplicity, competitiveness and anti-avoidance. The study shows that the eight consolidation regimes represent a spectrum of varying degrees of complexity, depending primarily on the alternative policy options for the key structural elements in them. For instance, New Zealand’s consolidation regime is relatively simple while achieving effectively most of the objectives of a consolidation regime. The analysis suggests that, though complexity is perhaps unavoidable for a consolidation regime, it is to a large extent manageable.

The comparative study also aims to answer the policy question of whether a stronger application of the enterprise doctrine necessarily implies a better consolidation regime on policy grounds. This study suggests that the answer is no. A stronger application of the doctrine tends to introduce complexity and problems into the system. Australia’s world-first “asset-based” model represents the strongest application of the enterprise doctrine among the eight countries. It offers a tax-friendly environment for corporate groups once they enter the consolidation regime. However, the price to pay for these advantages is high, especially at the transition points when a company goes into or gets out of the consolidation regime. It is one of the most complex regimes among the eight countries. Another problem of the strong application of the enterprise doctrine is the difficult interaction between consolidation and other parts of the income tax regimes. The comparative analysis suggests that the stronger the application of the enterprise doctrine is, the more difficult the interactions tend to be.
12.2.2 Search for a model consolidation regime

This comparative analysis intends to search for a model consolidation regime. As discussed in the previous section, this study points quite clearly to a predominant policy option in the eight countries in respect of six key structural elements which turn out to be also the preferred policy options on policy grounds. The six structural elements are the single entity concept, liability to tax, consolidation of group results, definition of a group, treatment of pre-consolidation losses and treatment of assets.

For the remaining four structural elements, namely election to consolidate, the "all in" rule, treatment of consolidated group's losses and treatment of intra-group shares, the eight countries exhibit considerable variations and reveal no clear preferred policy option. The divergent policies typically represent a trade off between competing policy objectives of simplicity, competitiveness and anti-avoidance.

Even if one can identify a model consolidation regime from this comparative analysis, it is important to note a critical qualification. The actual regime adopted in a country is often the product of not only difficult compromises between conflicting policy objectives, but also constraints imposed by existing tax regimes. Local circumstances and constraints should be carefully considered in the design of a consolidation regime. Transplanting foreign policies without due consideration of these issues is dangerous.

Experience suggests that once a consolidation regime is introduced, it is often a road of no return to the government. Businesses enjoy the benefits of intra-group loss offsets and tax free asset transfers under the regime. Repeal of the regime is therefore most likely politically unacceptable. Furthermore, once the structural elements are adopted in the regime, it is difficult to have a major
change of policies. Fine-tuning is often the only feasible approach in practice. Therefore, it is important for countries that contemplate the introduction of a consolidation regime to get the legislation right when it is first introduced. The comparative analysis of the eight countries provides a better understanding of the application of the enterprise doctrine in practice and the alternative policy options available for tax policy makers with respect to the key structural elements.

12.3 Limitations

This comparative study focuses on the key structural elements of a consolidation regime. Detailed discussion of each consolidation regime – which is often one of the most complex regimes in a tax system – is beyond the scope of this thesis. This study does not, and is not designed to, cover all detailed technical provisions of the eight consolidation regimes.

This study is also limited with respect to the availability of research materials in English. For countries where English is not the official language, the research of their consolidation regimes is confined to the materials available in English. Therefore, this study has relied partly on English translations of the relevant legislation. It is recognised that there may be significant risk of doing so. The risk is minimised as far as possible by double and counter checking of the translation against all other available resources, including databases and commentaries published by professional publishers, books and journal articles written on the consolidation regimes, reports prepared by international bodies on those regimes and tax experts in the respective countries.

Another limitation imposed by the availability of material in English is that the analysis is constantly tempted to be more detailed for the countries with English as their official language. The fact that the author is based in
Chapter 12 Conclusion

Australia tends to compound this problem for the analysis of Australia’s consolidation regime. The thesis has been written alert to this potential problem, and has strived to provide as far as possible a balanced comparative analysis among the eight countries.

12.4 Future research areas

This thesis focuses on consolidation regimes that represent one form of application of the enterprise doctrine to the taxation of corporate groups. The doctrine may be, and has been, applied in other forms of group taxation regimes. For future research, one possibility is to extend the consolidation concept to a multilateral level. Though the experience of the CCCTB project so far suggests that such a regime may not be promising, the increasingly dominant presence of multinational groups warrants continuous research in this area.

Another possible area worthy of further research is the application of the enterprise doctrine in the form of a general participation exemption regime for corporate groups. While it is common in the EU, the regime is rare in non-EU countries. This thesis has highlighted the problems of the dual cost base issues in respect of the key structural element of “intra-group shareholdings”, and the relative ease with which the EU countries have dealt with the issue. It may be interesting to explore the possibility of introducing a general participation exemption regime in countries outside the EU.
12.5 Conclusion

This thesis provides the first comprehensive comparative analysis of the consolidation regimes in eight countries, which by the end of the 2009, are the countries that have introduced a consolidation regime in their tax systems. The comparison and evaluation of the alternative policy solutions for the key structural elements advances knowledge and improves understanding of the application of the enterprise doctrine in consolidation regimes in practice. The findings of this study should be useful in assisting tax policy makers to design a new consolidation regime, as well as to refine existing consolidation regimes.
APPENDIX A
THE TAX COST SETTING RULES
IN AUSTRALIA

This Appendix provides a summary of the main provisions of the tax cost setting ("TCS") rules in Australia and analyses their problems with respect to the following issues:

(1) the TCS rules at joining time;
(2) the TCS rules at leaving time; and
(3) the TCS rules for multiple-entry consolidated ("MEC") groups.

A.1 The TCS rules at joining time
A.1.1 Basic operation
Diagram 29 summarises the steps required at joining time under the TCS rules:1

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A.1.2 Problems of the TCS rules at joining time

(1) Flawed theory, or no theory at all?

Theoretically, the acquisition cost of shares in a company should represent the net value of assets and liabilities in the company. The relationship may be presented in the following formula:

\[
\text{Share acquisition cost} = \text{Value of assets} - \text{Value of liabilities}
\]
Appendix A Tax Cost Setting Rules in Australia

Logically, it is possible – in theory at least – to allocate the share purchase cost to each individual asset, as the above formula can be rearranged as follows:

\[
\text{Value of assets} = \text{Share acquisition cost} + \text{Value of liabilities}
\]

However, the formula is true only at the time of share acquisition, but is no longer true once values of assets and liabilities change over time.

In many cases, shares in a subsidiary are acquired at a different time from the joining time. For instance, a parent company may have acquired all shares in a company in Year 1 and then forms a consolidated group in Year 10. Alternatively, the parent company may have acquired shares in a subsidiary in separate parcels at different times before the subsidiary joins the consolidated group. Similar problems apply to liabilities. Some accounting liabilities are measured at fair value, while others at amortised costs. Mixing items with different valuation times renders the TCS theory flawed.²

This “apples and oranges” problem has another dimension: the TCS calculation mixes tax and accounting items. While the cost bases of shares are determined under the tax rules, liabilities are identified and measured according to the accounting rules. For instance, deferred tax liabilities – an accounting concept that has no meaning in tax law – are included in the TCS calculation and effectively pushed down into the cost bases of assets. It is

² Some of the adjustments in the TCS calculation (for example, adjustments for certain pre-consolidation profits and losses in a joining subsidiary in Steps 3 to 5 of the ACA calculation) may alleviate some of the problems. However, the anomalous resulting reset cost bases – as is illustrated below in the “$74 land” example – suggest that the adjustments are not sufficient to deal with the problems.
doubtful if the amount – which is not a legal liability – should be included in the TCS calculation at all.3

The question is what we get by adding together tax items with accounting items and what the resulting “reset” cost base of an asset represents. It is difficult to find a satisfactory answer. Accounting liabilities include not only loans borrowed by a company to acquire assets, but also other items that have little, if any, relationship with the asset cost. For example, accounting liabilities include “provision for employee benefits” whose value may depend on the fair value of options over the company’s shares. Accounting liabilities for a supermarket chain may also include “provision for self-insured risks” which represents the estimated liability for workers’ compensation and public liability claims based on actuarial valuations. It is puzzling why these items—which basically are estimates required under the accounting standards for financial reporting purposes—should be included in the ACA and pushed down into the reset cost bases of assets in the company.4

The fact that a parent company may have a capital gain or loss in the TCS process is evidence of the flawed theory.5 It is difficult to comprehend why at

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4 What happens if the provision is different from the realised amount? It would be a nightmare if the TCS calculation has to be redone every time a provision is realised. The solution in Australia was to treat the difference as a capital gain or loss of the parent company: CGT event L7 under section 104-530 ITAA1997. However, there were many problems associated with the treatment and the government has repealed the provision in 2010. This means that over- or under-provisions in financial statements will become a permanent component in the reset cost bases under the TCS regime.

5 For example, a parent company may have a capital loss if some of the allocable cost amount can not be allocated to any asset: CGT Events L4 & L8 in sections 104-515 & 104-35
the joining time the parent company can have a capital gain or loss without any transfer of assets. Even under the SER, assets are just deemed to be those of the parent, without any deemed transfer of the assets.\(^6\) The only reason for the capital gain or loss is that it is artificially manufactured by the TCS rules.

Perhaps the better view is that the search for a theory behind the TCS rules is bound to be futile. Perhaps the TCS regime has no theory at all. It may be simply a mechanism designed to push down and store share acquisition cost in the underlying assets, waiting for it to be pushed back up to reconstruct the cost bases of shares when the subsidiary leaves consolidation.\(^7\) However, a regime without theory runs a high risk of producing arbitrary and anomalous results.

Detailed discussion of the highly technical and complex TCS calculations is beyond the scope of this thesis. Nevertheless, its problems become obvious if one looks at its end product: the "reset cost base" of an asset. The Australian Taxation Office ("ATO") Consolidation Reference Manual – which is prepared to assist taxpayers to understand how the consolidation regime works – ironically provides a telling example illustrating the problems of the TCS rules.\(^8\) In that example, when the parent company A acquired 40 per cent of a subsidiary G on 1 July 2001, G had a piece of land with both cost base and

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\(^6\) It is clear that the SER does not deem a transfer of assets from a joining subsidiary to the parent company: Note to section 701-35(3) ITAA1997. The government failed to provide any policy explanation for the CGT events at all: EM to New Business Tax System (Consolidation and Other Measures) Act 2003, paragraphs 5.127-5.131, & EM to Taxation Laws Amendment Act (No.8) 2003, paragraphs 2.19-2.23.

\(^7\) One may get this impression after reading the consultation document regarding the policy objective of "determining the cost base for disposal of equity": Review of Business Taxation, *A Platform for Consultation* (1999), Chapter 27.

\(^8\) ATO, Consolidation Reference Manual, Example in Section C2-2-110.
market value equal to $100. On 1 July 2002, A acquired the remaining 60 per cent in G and elected to consolidate. At that time, both the cost base and market value of the land remain $100.

After 16 pages of TCS calculations, the “reset” tax cost of the land is $74. The implication is that if the consolidated group sells the land for its market value of $100 (which is the same as its original cost base), the group would have a capital gain of $26. This “step-down” result defies common sense and logic.

This result is difficult to comprehend, given that both the “real” cost base and market value of the land have always remained $100 ever since A acquires shares in G. The intriguing question is why the group should have a capital gain of $26, when it sells the land for its original cost.

Combing through the complicated 16-page TCS calculations reveals the causes for this puzzling outcome:

(i) Appreciated assets in the group:
The subsidiary has other assets that have appreciated in value since 1 July 2001. As allocation is based on market values of assets at the joining time, more ACA is allocated to those assets than to the land (which has not appreciated in value).

(ii) New asset recognised at joining time (that is, 1 July 2002):

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9 It is beyond the scope of this thesis to explain the detailed technical calculations that results in this number. Nevertheless, the two main reasons for this puzzling outcome are discussed below.

10 What the ATO does not discuss in the example is that in practice, given the creativity of taxpayers, one would expect a step-up basis – instead of step-down – to be more likely.
Before the joining time, the parent company never recognises any goodwill in its investment in the subsidiary. However, at joining time, goodwill is recognised in the TCS calculation. As a result, part of the acquisition cost for the 40% shares on 1 July 2001 is allocated to the goodwill that was not recognised at that time.

In practice, the creativity of taxpayers and their advisors is likely to produce a reset cost base that is stepped-up instead of stepped-down. The TCS regime thus provides ample tax planning opportunities for corporate groups.

The “reset” cost bases will stay with the asset even if the subsidiary subsequently leaves consolidation. This is one of the implications of the “exit history rule”. The anomalous effect of this policy is again well illustrated by the “$74 land” example. The $74 will remain as the cost base of the land if the subsidiary leaves the group. This is so even though the market value of the land has always been $100 and the land has always been owned by the subsidiary throughout the consolidation cycle. In other words, the original “real” cost of the asset is lost forever once it passes through the consolidation process.11

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11 The reset cost bases of assets also have significant implications for the cost base of shares in the subsidiary: see the discussion in the following Section A.2 and Chapter 8 Section 8.4.
Appendix A Tax Cost Setting Rules in Australia

(2) Complexity
The TCS rules are very complex and occupy over 100 pages of legislation.\(^\text{12}\) The law requires that the cost bases of most assets in a group have to be reset on an asset by asset basis.\(^\text{13}\) Compliance costs are high. This is not helped by the requirement that a joining subsidiary has to prepare a “notional” balance sheet at the joining time (unless the joining time coincides with an accounting reporting date) in order to identify and measure accounting liabilities as at that day.\(^\text{14}\)

In practice, especially for large corporate groups, identification of all assets (especially intangibles) can be an art instead of science. The meaning of “assets” and “liabilities” is also controversial.\(^\text{15}\) Valuation of assets and liabilities is problematic. For example, it raises the question of how goodwill should be identified and valued, especially if it is internally generated.\(^\text{16}\)

\(^{12}\) Divisions 705 and 713 ITAA1997. As discussed above, when a subsidiary joins a consolidated group, first it has to go through an 8-step process to arrive at the “allocable cost amount”, which will be allocated to each individual asset of the company: Section 705-60 ITAA1997. This is just the first part of a 4-part process to complete the tax cost setting process. The whole process is repeated for every level of shareholdings in the consolidated group, until all costs of shareholdings are allocated to individual assets. The TCS calculations are so complex that the tax law stipulates that certain errors in the calculation would be taken to be correct if, among other things, they are worked out “in purported compliance” with the TCS rules: section 705-315 ITAA1997. In that case, the mistake will result in a capital gain or loss for the parent company. Detailed discussion of these technical rules is beyond the scope of this thesis.

\(^{13}\) Section 701-10(2) ITAA1997.

\(^{14}\) Section 705-70 ITAA1997.

\(^{15}\) The ATO has issued several tax rulings explaining its positions on the meanings of “asset” and “liability”: TR2004/13, TR2004/14 and TR2006/6. For an interesting illustration of the problems in relation to “liabilities” and the resulting “notorious provision” in the ACA rules (section 705-80 ITAA1997), see the “accrued $100 million liability for poisoned pies sold by a pie shop” example in Lehmann, above note 3, at 279.

\(^{16}\) The ATO has issued tax ruling TR2005/17 explaining its position on the issues.
Appendix A Tax Cost Setting Rules in Australia

Furthermore, the cost base resetting is based on the market values of assets in the subsidiary, thus requiring a major valuation exercise in many cases. Not surprisingly, some taxpayers encounter significant difficulties trying to comply with the rules in practice.\(^\text{17}\)

The administrative and policing costs of the ATO are also very high.\(^\text{18}\) The ATO recognises the practical difficulties of complying with the rules, and has to allow some pragmatic "short cuts".\(^\text{19}\)

(3) Avoidance opportunities

The complex TCS regime provides ample tax avoidance opportunities. Planning opportunities can arise from valuation of assets,\(^\text{20}\) different depreciation rates among assets, and the meaning of "assets" (especially identification of intangibles) and "liabilities".\(^\text{21}\) The adoption of accounting

\(^{17}\) For instance, some corporate groups have many thousands of assets, while others may operate different fixed asset systems (e.g. due to acquisitions). These problems are recognised a Practice Statement of the ATO: ATO, "PS LA 2004/12 Consolidation - General short cuts for resetting the tax cost under Division 705 of the Income Tax Assessment Act 1997 for depreciating assets for which the decline in value is worked out under Division 40 of that Act" (2004), paragraph 3.

\(^{18}\) In addition to the inherent problems associated with valuation of assets, the policing cost is particularly high as the tax cost setting rule can result in "step-up" basis of assets: ATO, PS LA 2004/12, paragraphs 7 & 10.

\(^{19}\) Both the ATO and the government recognise the problem. The ATO offers some short-cuts to reduce compliance costs of valuation: ATO, PS LA 2004/12. The government provided certain transitional measures to reduce compliance costs. In broad terms, groups that consolidated before 1 July 2004 could choose to keep the tax values of assets for certain subsidiaries, instead of calculating the "reset" cost bases under TCS regime: Division 701 Income Tax (Transitional Provisions) Act 1997. The transitional rules were optional. Furthermore, the parent company could choose which subsidiaries use the "stick" method on a company by company basis. In other words, groups consolidated in the transitional period could cherry pick the best options.

\(^{20}\) Valuation is particularly difficult and inherently subjective for intangibles, such as goodwill. Taxpayers in general would prefer a lower valuation of goodwill in the context of tax cost setting exercise, as goodwill is not eligible for depreciation in Australia.

\(^{21}\) For example, the meaning of "liability" in the context of the tax cost setting rules was the key issue in Envestra Ltd vs Commissioner of Taxation [2008] FCA 249.
liabilities in the TCS calculation provides further scope for manipulation, as accounting standards may allow a choice between alternative accounting policies.\textsuperscript{22} Furthermore, the implant of accounting liabilities into tax costs is prone to abuse as the "notional" balance sheet prepared for the joining time is not required to be audited, and the accounting concept of "materiality" implies more flexibility than would normally be acceptable for tax purposes.\textsuperscript{23}

Market valuation is critical in the TCS regime, as the ACA is allocated to assets generally according to their market values. The higher the market value is assigned to an asset, the higher its reset cost base will be. Ingenuity of taxpayers and their advisors is further encouraged by the fact that the TCS rules allow "step up" basis of an asset. For instance, it would be beneficial to allocate more ACA to depreciating assets than to goodwill which is not eligible for depreciation in Australia. Given that tax depreciation is a significant tax deduction item of many corporate groups, it is understandable that the ATO is particularly alert in policing market valuations adopted in the TCS exercise.\textsuperscript{24}

\textsuperscript{22} The ATO recognises the problem and tries to limit the scope for manipulation: TR2006/6 paragraphs 9 & 20. The ATO’s position was tested and confirmed in Envestra Ltd v FCT [2008] FCA 249.

\textsuperscript{23} Again, the ATO tries to limit the exposure, though it is not certain how effective it is: TR2006/6 paragraphs 13 & 14.

\textsuperscript{24} The ATO has prepared detailed market valuation guidelines explaining how it will administer the market valuation provisions in the consolidation regime: Part 4 of the Consolidation Reference Manual. In particular, it has developed the “Advanced Market Valuation Agreements” process. The AMVA concept is similar to transfer pricing Advanced Pricing Agreements and is designed to reduce uncertainties around the derivation and use of market values in consolidation. A proforma of an AMVA can be found in Part C4-I-110 of the Consolidation Reference Manual.
The ATO has issued a 45-page document discussing the application of the general anti-avoidance provision to elections to consolidate.\textsuperscript{25} One of the examples illustrates a situation under which the ATO would apply the provision to deny additional depreciation generated under the TCS rules by a consolidated group.\textsuperscript{26}

\textbf{A.2 The TCS rules at leaving time}\textsuperscript{27}

\textbf{A.2.1 Basic operation}

The cost bases of shares in a leaving subsidiary is reconstructed basically by adding the cost bases – including reset cost bases – of assets taken by the subsidiary, less its liabilities.\textsuperscript{28} The TCS steps for leaving subsidiaries can be depicted as follows:\textsuperscript{29}

\begin{table}
\centering
\begin{tabular}{|c|c|c|}
\hline
\textbf{Step} & \textbf{Description} & \textbf{Formula} \\
\hline
1 & \textbf{Initial cost base} & \textbf{Initial cost base} \\
\hline
2 & \textbf{Reset cost base} & \textbf{Initial cost base} + \textbf{Additions} - \textbf{Subtractions} \\
\hline
3 & \textbf{Subsidiary's liabilities} & \textbf{Initial cost base} - \textbf{Liabilities} \\
\hline
4 & \textbf{Transferee's cost base} & \textbf{Initial cost base} + \textbf{Additions} - \textbf{Subtractions} - \textbf{Liabilities} \\
\hline
\end{tabular}
\end{table}

\textsuperscript{25} ATO, "The application of Part IVA to elections to consolidate" (available at ATO website www.ato.gov.au), accessed on 19 October 2009. The document has been incorporated into the Consolidation Reference Manual: Part C9-1-220.

\textsuperscript{26} Ibid, Example 2 at page 9.

\textsuperscript{27} For a detailed technical discussion of the issues of the TCS rules at leaving time, see Tony Stolarek, "Leaving a consolidated group - Separation without tears" (2007) 11(2) Tax Specialist 110.

\textsuperscript{28} Section 711-5(3) ITAA1997.

\textsuperscript{29} Source: ATO, Consolidation Reference Manual, C2-1-060 page 3.
A.2.2 Problems of the TCS regime at leaving time

(1) Real cost of asset lost forever

As discussed in Section A.1.2 above, the TCS regime represents a “road of no return” for the original cost bases of many assets in a subsidiary. The “real” cost bases are lost forever and replaced by “reset” cost bases.

Step 1 of the “exit ACA” calculation stipulates that the reconstituted cost base of shares is primarily based on the cost bases of assets – including reset cost bases determined at joining time – that the subsidiary takes away from the
consolidated group. The "$74 land" example discussed in Section A.1.2 above illustrates vividly that the permanent replacement of the real cost base by the reset cost base is problematic.

(2) "Double troubles"
The "$74 land" example again illustrates the issue well. If the parent company sells all shares in the subsidiary holding the land to a third party and the price reflects the market value of the land ($100), the group would realise a gain of $26 attributable to the land. When the subsidiary subsequently sells the land, the same gain of $26 would be taxable again in the hands of the company. This duplication of gain is created due to the TCS regime. By going through the consolidation cycle, artificial gain not only can be created, but also duplicated.

(3) Complexity
The TCS process at leaving time is complex. If multiple levels of subsidiaries leave a consolidated group, the TCS calculation has to be performed for each level on a "bottom-up" basis. The implant of accounting liabilities in the calculation introduces additional complexity and adjustments.

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30 In contrast, if the subsidiary does not join the consolidated group, the cost base of the land would remain to be $100. Thus no gain would be recognised when it is sold for its market value $100.

31 The TCS regime is not the only cause for double taxation in consolidation. Capital gain might be subject to double tax under certain circumstances. For example double taxation would occur if the disposal contract is concluded during consolidation and the title transfer occurs after the subsidiary involved leaves the group. This was known as the "CGT straddles" issue. The ATO's bandaid solution was to allow taxpayers to ignore one of the gains: TD2008/29. In 2008, the government announced that it would introduce legislations to fix the problem. The tax law was finally amended in 2010, basically to override the general timing rules in the CGT regime in order to avoid the double taxation outcome: section 716-860 ITAA1997.


33 Many adjustments are required on the accounting liabilities at the leaving time: section 711-45 ITAA1997. The government has suggested amendments to reduce compliance costs in this
If the leaving subsidiary has more than one class of shares, or option/right over shares, the ACA is allocated to the different classes of membership interests according to their respective market values.\textsuperscript{34} Similar to the issues at joining time, the valuation requirement increases compliance costs of taxpayers, policing costs of the tax authority, and creates avoidance opportunities.

\textbf{(4) Failure to eliminate dual cost bases issue}

The primary objective of the asset-based model is to eliminate the dual cost bases issue by the “deemed disappearance” of intra-group shareholdings within a consolidated group. The objective is achieved for intra-group asset transfers and also for disposal of assets to a third party outside the group. However, it is not achieved if a subsidiary leaves the group with the asset. This is because any hidden reserve in the asset would be recognised twice: first in the gain on disposal of the shares in the subsidiary, and again when the subsidiary sells the asset. This means that the model fails to eliminate the dual cost bases issue comprehensively.\textsuperscript{35}

Consider the following example in Diagram 31 below:

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\textsuperscript{34} Section 711-15(1)(b) & (2) ITAA1997.

\textsuperscript{35} In contrast, a participation exemption regime that applies to both consolidated and non-consolidated groups would be more effective and comprehensive to deal with the issue.
If Companies A and B (together with other subsidiaries) elect to consolidate, the cost base of the asset would be reset to $100 (i.e. the cost of shares in B). If B is sold to a third party outside the group for $1,000, the group makes a gain of $900.\textsuperscript{36} If B then sells the asset for its market value, it will also realise a gain of $900, thus duplicating the same gain that has already been taxed in the hands of the consolidated group.

\textsuperscript{36} This is of course a simplified example. In practice, the market value of the share price depends on many other factors determining the price of the shares in B. Detailed discussion of the factors and the dual cost bases issue is beyond the scope of this thesis. For a detailed discussion of the issues and a summary of the corresponding policies in different countries, see Richard Vann, "General Report" in International Fiscal Association, Cahiers de Droit Fiscal International Volume 88a: Trends in company shareholder taxation: single or double taxation? (2003).
In summary, the TCS rules fail to eliminate the dual cost bases issue comprehensively. In contrast, a participation exemption regime is applicable to both consolidated and non-consolidated groups, and is more effective and comprehensive to deal with the issue.

A.3 The TCS rules for MEC groups

A.3.1 Basic operation

The consolidation regime in Australia has an unusual feature: it allows consolidation for foreign-owned groups that have multiple entry points in the country. The definition of a MEC group is discussed in Chapter 5 Section 5.2.

The logic of the TCS rules – which is argued to be flawed in Section A.1.2 above – is even more stretched with MEC groups. The question is whether the acquisition costs of shares in the ET1s should be pushed down to their assets when the MEC group is formed.37 One may argue that it should be, as the ET1s are in fact subsidiaries and not the parent company. The logic of the TCS rules would suggest that acquisition costs of shares in the ET1s should be pushed down to their assets.

In contrast, the government decided that each ET1 would be deemed to be part of the head company for TCS purposes.38 The implication is that cost bases of their assets would not be reset.39 The rationale, as argued by the government in the context of a joining ET1 to an existing MEC group, is that the policy “ensures neutrality between electing... the eligible tier-1 company [joining] a

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37 The same issue applies to the case of a new ET1 joining an existing MEC group.
38 Section 719-160(2) ITAA1997.
39 Section 719-160(2) ITAA1997, Note 2.
MEC group and electing ... the company [becoming] the head company of a consolidated group” (emphasis added).  

The MEC rules are in general more flexible and less disciplined than those for domestically-consolidated groups. There are two possible reasons for the asymmetric treatment. First, the MEC rules were developed in a relatively short period of time. To the surprise of tax practitioners who were involved in the consultation for MEC group rules, “the current quite liberal rules for MEC groups [were developed] after a consultation period of about a couple of months” (emphasis added). Apparently, the government was under intense time pressure as the rules were developed “in the last few months leading up to the release of the first instalment of the consolidation legislation”. Second, as the design of the consolidation regime was approaching conclusion, “the officials became more adventurous in what they were prepared to recommend to government ...”.

A.3.2 Problems at joining time

Problems of the TCS rules for MEC groups at joining time include:

(1) Conflicting objectives

The special TCS rules for MEC groups contradicts the general objective of the TCS regime, namely to align acquisition costs of subsidiaries to the costs of

40 Explanatory Memorandum (“EM”) to New Business Tax System (Consolidation and Other Measures) Act (No.1) 2002 (“September 2002 Consolidation Act”), paragraph 3.32. This is so because the joining ET1 can also form a separate consolidated group with its own subsidiaries, separate from the existing MEC group. The MEC regime is very flexible and provides more beneficial treatments to foreign owned groups than wholly domestic groups. The regime is discussed in more detail in Chapter 5 “Definition of a group”.

41 Lehmann, above note 3, at 274.

42 Ibid, at 282.

43 Ibid.
their underlying assets. ETIs are by definition wholly-owned subsidiaries of the parent company. Treating them as the head company is a fiction that arguably has pushed the logic too far.

However, the deeming of all ETIs to be one single holding company is perhaps the pragmatic way to make the consolidation regime works for MEC groups. The fact is that no other countries in the world allow consolidation for foreign owned groups in this way, thus potentially making the Australian consolidation regime attractive to foreign multinational groups.

(2) Not neutral
The policy may be neutral between the choice of being an ET1 of an existing MEC group or a head company of a new consolidated group. However, options are still wide open for corporate groups. For instance, the foreign parent company can choose between acquiring the company directly as an ET1 or indirectly as a subsidiary of one of its existing ETIs. The latter option means that assets of the joining company would have their cost bases reset under the normal TCS rules. The tax outcomes of the two options would therefore be very different. The policy not only violates the policy objective of neutrality, but also creates tax planning opportunities for corporate groups.

(3) Transferring ET1 up and down
The deeming of all ETIs as part of the head company raises the question of what should happen if an existing ET1 is “transferred down” the group structure, and say becomes a subsidiary of another ET1. The issue is whether its share acquisition cost should be then pushed down to its assets. The

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44 Surprisingly, the government was well aware of this possibility and almost seemed to be suggesting foreign groups to do so: EM to September 2002 Consolidation Act, paragraph 3.33.
A question of "transferring up" a subsidiary and "promote" it to become an ET1 is equally perplexing. The law does not provide clear answers to the questions.

A.3.3 Problems at leaving time

The logic of the TCS rules is again stretched by MEC groups at leaving time. As discussed in Section A.3.1 above, the cost bases of shares in ET1s are not reset at the joining or formation time. This policy not only contradicts the objective of the TCS rules of aligning the costs of shares and underlying assets of subsidiaries, but also creates problems at leaving time.

The question is what should the cost bases of shares in a leaving ET1 be. As assets can be transferred tax free within a MEC group, keeping the original cost base of the shares would provide ample avoidance opportunities. For example, assets may be transferred to an ET1 before the parent company sells the subsidiary to a third party. If the original cost bases of shares in the ET1 is used to calculate the capital gain on the disposal, the assets would have been effectively transferred out of the group tax free.

Australia comes up with a bold solution. At the leaving time of an ET1, cost bases of shares in all ET1s are pooled together, then apportioned to leaving ET1 based on its market value:45

\[
\text{Deemed cost of shares in leaving ET1} = \frac{\text{pooled cost bases of shares in all ET1s}}{\text{market value of the MEC group}} \times \text{market value of shares in the leaving ET1}
\]

45 Section 719-570 ITAA1997. In particular, the cost resetting process is activated if (1) a ET1 ceases to be a member of the MEC group, or (2) a CGT event (e.g. disposal) happens to shares in a ET1: s.719-555(1)(b) ITAA1997.
The government argued that such “resetting of the cost base from the pool facilitates the free transfer of assets within the group as it removes the need to make value shifting adjustments to the membership interests each time there is a transfer of value between MEC group members”.46

Valuation is again required in the process, thus increasing the compliance costs. In addition, as valuation is more likely to be an art than science, it is doubtful if such redistribution of the pooled cost bases can effectively reflects the transfer of underlying assets within the group.

The formula determining cost bases of shares of the remaining ETls in the MEC group is more puzzling. They are determined by spreading the remaining “pooled cost bases” evenly among the shares.47 The original cost bases of the shares are effectively redistributed among all the ETls in an arbitrary manner.

This arbitrary cost base allocation policy may be acceptable in Australia, as gain on disposal of shares in ETls by the non-resident parent company in most cases is not subject to tax.48 The non-taxability of future gains on shares in ETls perhaps explains why the government is tolerant of the arbitrary allocation of cost bases between ETls.

46 EM to September 2002 Consolidation Act, paragraph 3.17.
47 Section 719-570(2) ITAA1997.
48 In general, capital gains derived by a non-resident on disposal of shares in a resident company are not subject to capital gains tax in Australia: Division 855 ITAA1997. Exceptions to the general rule include shares in a resident company whose assets are mainly Australian real property.
This Appendix analyses, from a theoretical perspective, the alternative policy options for the treatment of assets at leaving time.

**B.1 Policy options**

In theory, alternative policy options of the treatment of assets at leaving time include:

(1) **Quarantine**

Under this alternative, tax attributes generated during consolidation would be quarantined at the group level. Pre-consolidation tax attributes that remain at leaving time are treated consistently, namely being quarantined at the subsidiary level. This alternative respects the transitions between the two doctrines and deals with the tax attributes accordingly.

(2) **Recapture tax benefits under rollover**

Rollover relief may have been allowed during consolidation and also at joining time. Under this policy, the tax benefits allowed under the rollover reliefs are recaptured at leaving time as the subsidiary is no longer part of the consolidated group.
Appendix B Policy Options for the Treatment of Assets at Leaving Time

(3) Deemed disposal
Under this alternative, assets taken by a leaving subsidiary away from a consolidated group would be deemed to have been disposed of to the subsidiary at market value. This policy option arguably provides a clear cut transition between the two doctrines.

(4) Rollover to leaving subsidiary
Under this policy option, the assets taken away by the leaving subsidiary from the consolidated group are rolled over to the former. There is no immediate tax implication at leaving time. Gain or loss on subsequent disposal of the asset is attributed wholly to the company.

The leaving issues under these alternative policy options are analysed below with the help of some examples, starting from the simplest scenario.

B.2 Scenario 1: Post-consolidation assets sold by subsidiary after leaving time
Assume a subsidiary of a consolidated group purchases an asset for $100 during consolidation, and leaves the group when the market value of the asset is $120 and eventually sells the asset for $150. The scenario is depicted below:
Appendix B Policy Options for the Treatment of Assets at Leaving Time

Diagram 32 Post-consolidation assets sold by subsidiary after leaving time

<table>
<thead>
<tr>
<th>Purchase asset:</th>
<th>Market value</th>
<th>Sell asset:</th>
</tr>
</thead>
<tbody>
<tr>
<td>cost $100</td>
<td>$120</td>
<td>$150</td>
</tr>
</tbody>
</table>

There are three alternative policies for this scenario:

(1) **Quarantine**
Under this alternative, the gain accrued during consolidation would be taxed in the hands of the group, while the gain accrued after subsidiary leaving would be taxed in the hands of the subsidiary. The timing of taxation is at the sale of the asset:

<table>
<thead>
<tr>
<th>Taxpayer</th>
<th>Taxable gain</th>
<th>Timing</th>
</tr>
</thead>
<tbody>
<tr>
<td>Group</td>
<td>$20</td>
<td>Upon sale of asset</td>
</tr>
<tr>
<td>Subsidiary</td>
<td>$30</td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>$50</td>
<td></td>
</tr>
</tbody>
</table>

The result is consistent with the transition from the enterprise doctrine to the separate entity doctrine. This alternative is also consistent with the realisation principle, that is, the gain of $50 is taxable only upon the actual disposal of the asset. Another advantage of this alternative is its deferral of taxing time rendering the regime more attractive to taxpayers.
However, this policy option has serious problems. Compliance and policing costs of tracing the asset and its market value until it is sold would likely to be significant. Another problem is that the value of the asset may fluctuate over time, as shown below:

**Diagram 33 Post-consolidation assets sold by subsidiary after leaving time – problem of value fluctuation**

<table>
<thead>
<tr>
<th>Purchase asset:</th>
<th>Market value</th>
<th>Sell asset:</th>
</tr>
</thead>
<tbody>
<tr>
<td>cost $100</td>
<td>$120</td>
<td>$80</td>
</tr>
</tbody>
</table>

The issue is how should the overall loss of $20 be allocated. A strict application of the quarantine policy would suggest the following:

<table>
<thead>
<tr>
<th>Taxpayer</th>
<th>Gain/(loss)</th>
<th>Timing</th>
</tr>
</thead>
<tbody>
<tr>
<td>Group</td>
<td>$20</td>
<td>Upon sale of asset</td>
</tr>
<tr>
<td>Subsidiary</td>
<td>$(40)</td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>$(20)</td>
<td></td>
</tr>
</tbody>
</table>

It would appear inappropriate to tax the group on the $20 "gain" while in fact the asset is disposed of at a loss of $20. Levying tax on the "never-realised" gain at the time of actual disposal at a loss would be difficult to justify, and be regarded as unfair.
(2) Deemed sale

Under this alternative, the asset is deemed to have been sold by the consolidated group to the subsidiary at market value at leaving time. The tax consequences can be summarised as follows:

<table>
<thead>
<tr>
<th>Taxpayer</th>
<th>Taxable gain</th>
<th>Timing</th>
</tr>
</thead>
<tbody>
<tr>
<td>Group</td>
<td>$20 (unrealised)</td>
<td>Upon leaving</td>
</tr>
<tr>
<td>Subsidiary</td>
<td>$30</td>
<td>Upon sale of asset</td>
</tr>
<tr>
<td>Total</td>
<td>$50</td>
<td></td>
</tr>
</tbody>
</table>

This alternative is also consistent with the transition between the two doctrines. The problem of this alternative is that it violates the realisation principle by taxing unrealised gain of $20 at the leaving time. Corporate groups are unlikely to welcome immediate taxation of unrealised gains.

The “never-realised gain” issue also applies to this alternative. If the asset is subsequently sold by the ex-subsidiary for $80 after leaving the consolidated group, the tax outcome would be as follows:

<table>
<thead>
<tr>
<th>Taxpayer</th>
<th>Gain/(loss)</th>
<th>Timing</th>
</tr>
</thead>
<tbody>
<tr>
<td>Group</td>
<td>$20 (unrealised)</td>
<td>Upon leaving</td>
</tr>
<tr>
<td>Subsidiary</td>
<td>$(40)</td>
<td>Upon sale of asset</td>
</tr>
<tr>
<td>Total</td>
<td>$(20)</td>
<td></td>
</tr>
</tbody>
</table>

The tax outcome is basically the same as for the quarantine alternative, except that the taxing time of the unrealised gain of $20 is accelerated. In this respect, one may argue that this policy is less friendly to taxpayers. However, governments may prefer this option as the regime would be simpler to
administer since it is not necessary to trace the asset until actual disposal by the ex-subsidiary.

(3) Rollover to leaving subsidiary
The tax outcome under this scenario is as follows:

<table>
<thead>
<tr>
<th>Taxpayer</th>
<th>Gain/(loss)</th>
<th>Timing</th>
</tr>
</thead>
<tbody>
<tr>
<td>Group</td>
<td>$0</td>
<td>Upon sale of asset</td>
</tr>
<tr>
<td>Subsidiary</td>
<td>$50</td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>$50</td>
<td></td>
</tr>
</tbody>
</table>

The advantage of this policy option is simplicity. No tracing or valuation of the asset is required. However, it violates the enterprise doctrine, as the rollover relief should apply only if the subsidiary remains to be part of the consolidated group. Furthermore, the deferral of the taxation time until the actual disposal of the asset by the subsidiary may not be acceptable to most governments.

B.3 Scenario 2: Pre-consolidation asset sold by subsidiary after leaving time
The second scenario is more complicated as it involves pre-consolidation assets. Assume that a company purchases an asset at $100, and then joins a consolidated group when the market value of the asset is $120. The subsidiary leaves the group when the asset has a market value of $180, and eventually sells the asset for $200. The asset remains in the hands of the subsidiary throughout the whole period. The scenario can be depicted as follows:
Diagram 34 Pre-consolidation assets sold by subsidiary after leaving time

<table>
<thead>
<tr>
<th>Purchase asset:</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>cost $100</td>
<td></td>
</tr>
<tr>
<td>Market value $120</td>
<td></td>
</tr>
</tbody>
</table>

Consolidation

<table>
<thead>
<tr>
<th>Sell asset:</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Market value $180</td>
<td></td>
</tr>
<tr>
<td>$200</td>
<td></td>
</tr>
</tbody>
</table>

There are several alternative policies for this scenario:

(1) Quarantine
Under this alternative, the total gain of $100 is attributed to the subsidiary and the consolidated group as follows:

<table>
<thead>
<tr>
<th>Taxpayer</th>
<th>Taxable gain</th>
<th>Timing</th>
</tr>
</thead>
<tbody>
<tr>
<td>Group</td>
<td>$60</td>
<td></td>
</tr>
<tr>
<td>Subsidiary</td>
<td>$40</td>
<td>Upon sale of asset</td>
</tr>
<tr>
<td>Total</td>
<td>$100</td>
<td></td>
</tr>
</tbody>
</table>

This alternative again is consistent with both the transitions between the two doctrines and the realisation principle. However, the compliance and policing costs would likely to be significant and the potential taxation of "never realised gain" is problematic.

(2) Rollovers at both joining and leaving time
Under this alternative, the cost base of the asset is rolled over to the consolidated group at joining time. At leaving time, the cost base is again
rolled over to the subsidiary. The tax implication is summarised in the following table:

<table>
<thead>
<tr>
<th>Taxpayer</th>
<th>Taxable gain</th>
<th>Timing</th>
</tr>
</thead>
<tbody>
<tr>
<td>Group</td>
<td>$0</td>
<td>Upon sale of asset</td>
</tr>
<tr>
<td>Subsidiary</td>
<td>$100</td>
<td>Upon sale of asset</td>
</tr>
<tr>
<td>Total</td>
<td>$100</td>
<td></td>
</tr>
</tbody>
</table>

This alternative fails to reflect the transitions between the two doctrines, as the portion of gains attributable to the period of consolidation is still taxed in the hands of the subsidiary. However, it is relatively simple compared to the others. Taxpayers would welcome the deferral of the taxing time until actual disposal of the asset. In contrast, governments may be less enthusiastic to the deferral of taxing time, and may prefer to recapture the deferred gain at leaving time.

**3) Rollover at joining time and recapture at leaving time**

Under this alternative, the cost base of the asset is rolled over to the group at joining time. At leaving time, gain accrued during consolidation is taxed in the hands of the group. The tax outcome is summarised as follows:

<table>
<thead>
<tr>
<th>Taxpayer</th>
<th>Taxable gain</th>
<th>Timing</th>
</tr>
</thead>
<tbody>
<tr>
<td>Group</td>
<td>$80 (unrealised)</td>
<td>Upon leaving</td>
</tr>
<tr>
<td>Subsidiary</td>
<td>$20</td>
<td>Upon sale of asset</td>
</tr>
<tr>
<td>Total</td>
<td>$100</td>
<td></td>
</tr>
</tbody>
</table>

This alternative is inconsistent with the transition between the two doctrines at joining time, as the $20 gain accrued before the joining time is taxed in the hands of the group, instead of the subsidiary. The taxation of unrealised gain
of $80 is also problematic, namely violating the realisation principle and suffering from the "never-realised gain" issue. However, this alternative has the advantage of avoiding tracing assets after the leaving time.

(4) Deemed sale
Under this alternative, the asset is deemed to have been sold at market value at both joining and leaving time. The tax implications are as follows:

<table>
<thead>
<tr>
<th>Taxpayer</th>
<th>Taxable gain</th>
<th>Timing</th>
</tr>
</thead>
<tbody>
<tr>
<td>Subsidiary</td>
<td>$20 (unrealised)</td>
<td>Upon joining</td>
</tr>
<tr>
<td>Group</td>
<td>$60 (unrealised)</td>
<td>Upon leaving</td>
</tr>
<tr>
<td>Subsidiary</td>
<td>$20</td>
<td>Upon sale of asset</td>
</tr>
<tr>
<td>Total</td>
<td>$100</td>
<td></td>
</tr>
</tbody>
</table>

This alternative is consistent with the transitions between the two doctrines, but violates the realisation principle. Taxation of unrealised gain would suffer from the disadvantages discussed above.

B.4 Scenario 3: Pre-consolidation asset sold by subsidiary after intra-group transfer and after leaving time
In this scenario, Subsidiary 1 purchases an asset before joining time, and transfers it to Subsidiary 2 during consolidation. Subsidiary 2 then leaves the group and sells the assets. The scenario can be depicted in the following diagram:
Diagram 35 Pre-consolidation assets sold by subsidiary after intra-group transfer and after leaving time

<table>
<thead>
<tr>
<th>Action</th>
<th>S1 buys asset:</th>
<th>Transfer asset from S1 to S2 when m.v. = $160</th>
<th>S2 sells asset:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost</td>
<td>$100</td>
<td></td>
<td>$200</td>
</tr>
<tr>
<td>m.v.</td>
<td>$120</td>
<td></td>
<td>$180</td>
</tr>
<tr>
<td>Consolidation</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Under consolidation, the intra-group transfer of asset would be tax neutral in accordance with the enterprise doctrine. There are again a number of alternative policies for this scenario:

(1) Quarantine
Under this alternative, gains accrued during ownership by S1, S2 and the consolidated group are quarantined. The tax outcome is summarised as follows:

<table>
<thead>
<tr>
<th>Taxpayer</th>
<th>Taxable gain</th>
<th>Timing</th>
</tr>
</thead>
<tbody>
<tr>
<td>S1</td>
<td>$20</td>
<td></td>
</tr>
<tr>
<td>Group</td>
<td>$60</td>
<td></td>
</tr>
<tr>
<td>S2</td>
<td>$20</td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>$100</td>
<td>Upon sale of asset</td>
</tr>
</tbody>
</table>

This alternative is consistent with both transitions between the two doctrines and the realisation principle. The table also shows that the quarantine policy identifies precisely the taxpayers corresponding to each period of ownership. Its advantages and disadvantages are basically the same as those for Scenario 2(1) above.
(2) **Rollovers at joining time, intra-group transfer and leaving time**

Similar to Scenario 2(2) above, the tax outcome is that the whole amount of gain of $100 is taxed in the hands of S2. It fails to reflect properly the transitions between the two doctrines, and has basically the same advantages and disadvantages as Scenario 2(2).

One important difference with Scenario 2(2) is that by transferring the asset from S1 to S2 tax free, the tax liability on the whole amount of $100 gain is shifted to S2. This creates avoidance opportunities. Specific anti-avoidance rules would be required to deal with abuse.

(3) **Rollover at joining time and intra-group transfer, and recapture at leaving time**

Again, similar to in Scenario 2(3) above, the tax outcome can be summarised as follows:

<table>
<thead>
<tr>
<th>Taxpayer</th>
<th>Taxable gain</th>
<th>Timing</th>
</tr>
</thead>
<tbody>
<tr>
<td>Group</td>
<td>$80 (unrealised)</td>
<td>Upon leaving</td>
</tr>
<tr>
<td>S2</td>
<td>$20</td>
<td>Upon sale of asset</td>
</tr>
<tr>
<td>Total</td>
<td>$100</td>
<td></td>
</tr>
</tbody>
</table>

This alternative fails to reflect properly the transition between the two doctrines at joining time, and violates the realisation principle. It has basically the same advantages and disadvantages as Scenario 2(3) above.

A variation of this scenario is to allow rollovers until the asset leaves the group, but the taxable amount at the leaving time is only the amount of rollover allowed at the time of intra-group transfer (i.e. $60):
Appendix B Policy Options for the Treatment of Assets at Leaving Time

<table>
<thead>
<tr>
<th>Taxpayer</th>
<th>Taxable gain</th>
<th>Timing</th>
</tr>
</thead>
<tbody>
<tr>
<td>Group</td>
<td>$60 (unrealised)</td>
<td>Upon leaving</td>
</tr>
<tr>
<td>S2</td>
<td>$40</td>
<td>Upon sale of asset</td>
</tr>
<tr>
<td>Total</td>
<td>$100</td>
<td></td>
</tr>
</tbody>
</table>

This version represents a weaker application of the enterprise doctrine, as the transferor company is still regarded to certain extent as a separate entity from the parent company at the time of the intra-group transfer.

(4) Deemed sales
The tax outcome under this alternative can be summarised as follows:

<table>
<thead>
<tr>
<th>Taxpayer</th>
<th>Taxable gain</th>
<th>Timing</th>
</tr>
</thead>
<tbody>
<tr>
<td>S1</td>
<td>$20 (unrealised)</td>
<td>Upon joining</td>
</tr>
<tr>
<td>Group</td>
<td>$60 (unrealised)</td>
<td>Upon leaving</td>
</tr>
<tr>
<td>S2</td>
<td>$20</td>
<td>Upon sale of asset</td>
</tr>
<tr>
<td>Total</td>
<td>$100</td>
<td></td>
</tr>
</tbody>
</table>

Despite properly reflecting transitions between the two doctrines, this alternative violates the realisation principle. It has basically the same advantages and disadvantages as Scenario 2(4) above.

B.5 Summary
The advantages and disadvantages of the alternative policy options of the treatment of assets at leaving time are summarised in Table 12 below:
Table 12 Alternative policy options for the treatment of assets at leaving time

<table>
<thead>
<tr>
<th>Policy option</th>
<th>Transition between the two doctrines</th>
<th>Realisation principle</th>
<th>Attractiveness to taxpayers</th>
<th>Simplicity</th>
</tr>
</thead>
<tbody>
<tr>
<td>Quarantine</td>
<td>✓</td>
<td>✓</td>
<td>✓ / X</td>
<td>X</td>
</tr>
<tr>
<td>Rollovers</td>
<td>X</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>Rollover + Recapture</td>
<td>✓ / X</td>
<td>X</td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td>Deemed Sale</td>
<td>✓</td>
<td>X</td>
<td>X</td>
<td>X</td>
</tr>
</tbody>
</table>

Note:
1. The quarantine policy is attractive to taxpayers as the taxation time is deferred until actual disposal of the assets. However, the possibility of taxing "never realised gains" reduces its attractiveness.
2. The "rollover + recapture" policy respects the transition between the two doctrines at leaving time, but fails to do so at joining time.

The above analysis suggests that the quarantine option is theoretically superior but practically a nightmare. The complexity of tracing assets after leaving time and the recalculation of gains attributable to different taxpayers (for example, the group and subsidiaries) is unlikely to be acceptable in practice.
APPENDIX C

MULTILATERAL CONSOLIDATION
– THE CCCTB EXPERIENCE

This Appendix supplements Chapter 11 providing more information and analysis of the problems of the multilateral FA model, drawing substantially from the experience of the Common Consolidated Corporate Tax Base ("CCCTB") project in the EU and the documents produced by the CCCTB Working Group. The extensive consultation and sometimes heated debates on the proposed CCCTB regime provide a unique and significant opportunity to highlight the problems of applying the multilateral FA model in the real world. This Appendix, together with Chapter 11, serves to document this reality check of the model.

To facilitate the discussion of the numerous issues, the analysis is structured around four major categories of problems of the multilateral FA method, as depicted in Diagram 36 below:
The four categories of problems are:

(1) arbitrariness;
(2) complexity;
(3) tax avoidance; and
(4) political resistance.

C.1 Arbitrariness

The critical issue of a cross-border FA model is the allocation of tax base among jurisdictions. The mismatch between the political spans of jurisdictions and the economic spans of corporate groups is the core issue of
any taxation systems for multinational corporate groups. The allocation exercise has been described to be as difficult as “slicing a shadow”.¹

An arbitrary allocation of tax base would produce unfair results. Fairness is one of the cornerstones of an international income tax system.² Although the concept of fairness is more readily applied to individual taxpayers, a corporation is an “essential halfway house” for income flowing to individual shareholders and similar principles should apply to its taxation.³ As shown below, the group-bloc model can produce arbitrary and thus unfair allocation of tax base among jurisdictions. The arbitrariness of a multilateral FA model is caused primarily by the following issues:

(1) different income-generating power of factors between jurisdictions;
(2) different income-generating factors for passive and active business income;
(3) mechanical generic formula;
(4) multiple-business corporate groups;
(5) different income-generating factors for specific industries;


² Michael J Graetz, “The David R. Tillinghast lecture: Taxing International income: inadequate principles, outdated concepts, and unsatisfactory policies” (2001) 54(Spring) Tax Law Review 261, at 307. This is not the place for detailed discussion of the concept of fairness, especially in international context. There is huge literature on the issue, see for example the classic work of Musgraves: Richard A Musgrave and Peggy B Musgrave, “International Equity” in Richard M Bird and John F Head (eds), Modern Fiscal Issues: Essays in Honor of Carl S. Shoup (1972, University of Toronto Press, Toronto); and Graetz, ibid, at 297-307.

Appendix C Multilateral Consolidation – CCCTB Experience

(6) scope of factors: theory vs reality;
(7) valuation of factors: theory vs reality; and
(8) interaction between the enterprise doctrine and the separate entity doctrine: “no-where sales”.

Each of these issues is discussed in more detail below.

C.1.1 Different income-generating power of factors between jurisdictions

This problem arises due to the different productivity and profitability of each dollar of payroll, property and sales between jurisdictions. A fundamental underlying assumption of a generic allocation formula under the FA method is that the income-generating power of factors is the same in every jurisdiction. This is clearly wrong. For instance, the fact that multinationals have been racing to set up manufacturing facilities in China suggests strongly that a dollar of payroll cost spent in China has a very different profitability implications to a dollar of payroll cost in, for example, the U.S. Allocation of tax base under the fundamentally wrong assumption would inevitably produce arbitrary results.

Theoretically, the formula may incorporate adjustments to reflect the different income-generating power of factors in different jurisdictions. However, it would create complexity and controversies, and no system in practice has such an adjustment mechanism. On this issue, one should be careful in relying on existing models (such as those in the U.S. states). Differences in productivity and profitability are greater on a global than on a domestic basis. The distortion is magnified if one attempts to apply the FA method currently

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4 Coffill & Willson Jr, above note 1, at 1116.
5 Ibid.
adopted by sub-federal governments in a relatively homogeneous county (for example, states in the U.S.) to a regime covering different countries. In summary, a cross-border FA method without adjustments for income-generating power in different jurisdictions is fundamentally flawed.

The EC faced serious problems on this issue. In particular, it was controversial when some Member States argued for adjustments in the formula to compensate for the different wage levels among jurisdictions.\(^6\) This particular issue is analysed in more detail in the discussion of the "payroll" factor in Section C.2.4.2.4.2(c) below.

### C.1.2 Different income-generating factors for passive and active business income

The primary objective of the FA method is to allocate tax base of a group to jurisdictions according to the income-generating factors located in each jurisdiction. The traditional 3-factor formula (namely payroll, asset and sales) "was developed primarily for manufacturing and mercantiling companies".\(^7\) It is questionable if such a formula is appropriate to allocate passive income and capital gains, or even business income of service industries. For example, it may be argued that capital gains on disposal of immovable property should be allocated exclusively to the country where the property is located.\(^8\) It is equally convincing to argue that passive income, such as dividend income, should not be allocated based on factors such as payroll, assets and sales.

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\(^6\) For example, see European Commission, "CCCTB: possible elements of the sharing mechanism" (CCCTB\WP\060, CCCTB WG, 2007) ("WP60"), paragraph 26.


\(^8\) European Commission, "The mechanism for sharing the CCCTB" (CCCTB\WP\047, CCCTB WG, 2006) ("WP47"), paragraph 8.
Royalty income provides an interesting example. On one hand, intangible assets are typically excluded from the “asset” factor due to practical concerns (for example, difficult to determine its location and valuation; and prone to manipulation). On the other hand, royalty income that they generate is in general included in the tax base to be allocated by the formula. This arguably violates the fundamental theory of the FA method, which aims to allocate the tax base according to the factors generating that tax base. If royalty income generated by an intangible asset is allocated based on a formula that does not include that intangible asset as a factor, the result would be detached from economic reality.

The issue represents a dilemma for the FA method. If a formula – which is primarily designed for active business income – is applied to passive income, the resulting allocation would be arbitrary and contradict with the objective of the FA method. However, if different formulae are used for active and passive income, the system would be more complex and subject to disputes. For instance, countries may disagree on the classification of particular items of income (for example, substantial capital gain from sale of subsidiary), as the classification would determine which country can collect the tax revenue.

The EC experts are divided on this issue. While the Commission is inclined towards a generic formula for all types of income, some experts believe that “non-business income (mainly passive income such as interest, royalties and

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9 For experience in the U.S. on this issue, see Michael J McIntyre, “The Use of Combined Reporting by Nation States” (2004) 35 Tax Notes International 917, at 922. Some states even exclude disposal proceeds from sale of intangibles from the “sales” factor: ibid.

10 This system of multiple allocation methods was suggested by Paul McDaniel for NAFTA region: McDaniel, above note 7, at 720-722.

The latter position is arguably the better position as it would produce a fairer allocation of the tax base. However, the EC is not in favour of it, believing that a generic formula approach “is the simplest one”.

In practice, many FA formulae currently used by states in the U.S. do distinguish between passive and active income. This is due to constitutional limitations on the taxation of non-business income by the states. However, such limitation would not be relevant to cross-border FA systems at federal level.

The generic formula approach is likely to be the model to be proposed by the EC. The resulting allocation is therefore bound to be arbitrary and unfair.

C.1.3 Mechanical generic formula

Under the enterprise doctrine, the taxable unit is the group as a whole instead of individual group members. The group’s worldwide profit is therefore the tax base to be allocated to jurisdictions that have taxing rights under the FA regime. A generic formula that is applicable to most cases and acceptable to all parties concerned is a necessary component of a viable FA system:

\[ \text{12 WP60, paragraph 15.} \]
\[ \text{13 European Commission, “Report and overview of the main issues that emerged during the discussion on the sharing mechanism” (CCCTB\WP\056, CCCTB WG, 2007) (“WP56”), paragraph 5.} \]
\[ \text{14 The distinction caused enormous “complexities of classifying various items of income as business or non-business income”: Coffill & Willson Jr, above note 1, at 1112. See also McIntyre, above note 9, at 946.} \]
\[ \text{15 The EC proposed that “all taxable income, i.e. business and non-business income, earned by the group should be consolidated and apportioned on the basis of the given formula ...”: WP60, paragraph 15.} \]
... any viable new international tax order [for direct investment] must to a large extent rest on precisely the ... worldwide allocation approach ...

What is needed ... to make such a system viable is primarily agreement on the formula by all parties concerned.

Unfortunately, such a generic formula is bound to be arbitrary and fail to take into account specific circumstances of each corporate group. Take an example of a mining group in Australia selling its products to the U.S. What should be a fair allocation of its worldwide profits between Australia and the U.S. under a FA system? The essential weakness of a FA system is that it is not a standard at all. Unlike the arm’s length standard, it provides no guidance on what the appropriate allocation should be. Each of the following mutually exclusive allocation methods is equally consistent with the FA method:

(i) Australia taxes all profits based on one single allocation factor: “asset”.

(ii) The U.S. taxes all profits based on one single allocation factor: “sales by destination”.

(iii) Australia and the U.S. share the group’s profits based on the traditional three-factor formula: asset, payroll and sales.

The example illustrates that “there is vast room for honestly held and irreconcilable differences between sovereigns over the results that formula apportionment should produce”; the FA method is therefore dubbed as a “design for disagreement”.

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17 Wilkins & Gideon, above note 1, at 1261. The following example is based on the example in the article.

18 A single factor of “sales by origin” would produce the same result.

19 Wilkins & Gideon, above note 1, at 1261.
Proponents of the FA method typically argue that the system works on an “overall” basis. Their arguments typically go like this: whatever factors the generic formula adopt eventually, the fact that jurisdictions agree to it proves that each jurisdiction is happy with the allocation formula, and believes that the formula would produce an acceptable or fair allocation on an “overall” basis.

The problem with this argument is obvious. Up until now, despite extensive debates and discussion on the multilateral FA model, no such system exists in practice. This is a strong indication that mutual agreement to a “fair” allocation formula is extremely difficult, if not impossible, to achieve.

Nevertheless, the EC has been very diligent working on the CCCTB proposal. It recognises that the “mechanical” nature of the generic formula can be problematic, and proposes a “safeguard clause” to avoid “unfair” results. Interestingly, the proposal is the result of “strong and unanimous recommendation by US and Canadian tax administrations”.

Based on actual implementation experience, they are well aware that “it is practically inevitable that specific individual cases would arise where the standard allocation formula would lead to results that would be perceived to be ‘unfair’”.

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20 WP60, paragraph 71.

21 European Commission, “Summary record of the meeting of the common consolidated corporate tax base working group” (CCCTB/WP/059, CCCTB WG, 2007) (“WP59”), paragraph 30. Some EU experts “remain rather sceptical” of the need for such clause: WP56, paragraph 42.

22 WP56, paragraph 42.
Appendix C Multilateral Consolidation – CCCTB Experience

It is doubtful if the clause would be effective in practice, as its application is intended to be very restrictive. The clause would apply only in "very exceptional cases" and any adjustment "should be commonly agreed by the tax administrations concerned and not be granted ... unilaterally". Experience in the U.S. is not encouraging. The safeguard clause is rarely invoked at the request of taxpayers, and even when it is invoked the relief is "granted, if at all, only after litigation is instigated by a taxpayer".

In summary, the generic formula is mechanical and can produce arbitrary and unfair results. The safeguard clause is likely to be of very limited use in practice.

C.1.4 Multiple-business corporate groups
In the modern commercial world, it is not uncommon for multinationals to have multiple lines of businesses. Under the enterprise doctrine, such a group should be treated as one single enterprise as long as subsidiaries are under the common control of the parent company. If one single formula is used to allocate the group’s worldwide profits to jurisdictions, the result is bound to be arbitrary. This is because the income-generating factors for each business line would most likely to be different.

One solution proposed by the EC is to apply industry-specific formulae to certain industries, such as "financial services, transportation services such as airlines and railways, and television and broadcasting services". This approach is pragmatic but has two problems. First, it makes the FA regime more complex, countering the claim that it will make the corporate tax system

23 WP60, paragraph 71.
24 Coffill & Willson Jr, above note 1, at 1110-1111.
25 WP60, paragraph 69.
Appendix C Multilateral Consolidation – CCCTB Experience

simpler. Second, and perhaps more importantly, the approach effectively brings back the problems of transfer pricing – the “devil” that the FA method is designed to conquer. Many groups are highly integrated economically, functionally and financially. To separate the group into different businesses and allocate income and expenses among them would inevitably encounter the familiar notorious problems of transfer pricing. The FA method in practice would not remove the transfer pricing problems as effectively as many proponents have claimed.

Another possible solution to the issue of multiple-business groups is to exclude specific industries (for example, financial services) from the definition of a “group” under the FA method.26 This approach is not pursued by the EC. In any case, this alternative suffers from the same problem, namely bringing back the complex transfer pricing issues.

C.1.5 Different income-generating factors for specific industries
A generic formula has the clear advantage of simplicity. However, the real world is much more complicated. Each corporate group is different and likely to have different income-generating factors and weightings attached to them. Applying a generic formula to all groups is therefore bound to be arbitrary and unfair.

One example of this issue is specific industries. The question is whether we should have different formulae for specific industries, and if so, how many industries should qualify for this treatment. These are difficult issues to

26 For example, see European Commission, “Issues related to group taxation” (CCCTB/WP/035, CCCTB WG, 2006) (“WP35”), paragraph 27. Similar policy has been adopted in the definition of a “group” under consolidation regimes in Australia, New Zealand and the U.S., etc. See Chapter 5 Section 5.3 for more detail.
resolve. Experiences in the U.S. and Canada demonstrate the complexity and difficulties involved.27

C.1.6 Scope of factors: theory vs reality
This issue is discussed in Chapter 11 Section 11.5.2(5).

C.1.7 Valuation of factors: theory vs reality
The designers of a FA regime have to face similar dilemma between theory and practice with respect to the valuation of the allocation factors. This issue is discussed in Chapter 11 Section 11.5.2(6).

C.1.8 “No-where sales”
The “no-where sales” issue is discussed in Chapter 11 Section 11.5.2(7). The following numeric example illustrates the problems and alternative solutions.28

Assume the bloc has three countries A, B and C, and a group has its parent company located in A and a subsidiary in B, as depicted in Diagram 37 below:

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27 See Section C.2.4.1 below for more discussion of this issue.
28 This example is based on a case discussed in the EC: WP60, paragraph 59.
Assume further that (i) the parent makes 20 per cent of its sales to the subsidiary, and 80 per cent to a third party in Country C; and (ii) the parent and the subsidiary each has 50 per cent of payroll and asset factors.

The 80 per cent sales to Country C are a “no-where sales”, as the group has no PE or subsidiary in the country. The locations of the sales factor of the group may be as follows:
Table 13 Alternative policy options for “no-where sales”

<table>
<thead>
<tr>
<th>Approach</th>
<th>A</th>
<th>B</th>
<th>C</th>
</tr>
</thead>
<tbody>
<tr>
<td>Theory</td>
<td>-</td>
<td>20%</td>
<td>80%</td>
</tr>
<tr>
<td>Throw-out</td>
<td>-</td>
<td>100%</td>
<td>-</td>
</tr>
<tr>
<td>Throw-back</td>
<td>80%</td>
<td>20%</td>
<td>-</td>
</tr>
<tr>
<td>Spread throw-back (*)</td>
<td>40%</td>
<td>60%</td>
<td>-</td>
</tr>
</tbody>
</table>

(*) Under the spread throw-back rule, the 80% “no-where sales” is allocated to Countries A and B according to their respective shares of the asset and payroll factors. As a result, B would share 20% + 80% x 50%, i.e. 60% of the sales factors.

Theoretically, Country C should have 80 per cent of the sales factor, as 80 per cent of the group’s sales are made to the country. However, the EC rejected this option as it contradicts the prevailing international tax norms that require a PE before the country can have taxing right on the profits.

For the remaining three options, none of them has any consistent theoretical basis. The throw-out rule simply disregards the 80 per cent sales, thus contradicting the “demand side income-generating” rationale behind the sales by destination factor. The throw-back rule effectively applies the “sales by origin” basis on the 80 per cent sales, thus again contradicting the “sales by destination” basis generally applied to the sales factor. The spread throw-back position appears to be a compromise between the throw-out and throw-back rules, without any proper theoretical or practical reasons to support.

More importantly, the “no-where sales” issue highlights the arbitrariness of the FA method. Each of the options may be appropriate in different situations, depending on the particular circumstances of a group. For instance, going back to the example above, the throw-back rule may be
appropriate for a group whose sales activities are concentrated and performed primarily by the subsidiary in Country B. Alternatively, the spread throw-back rule may be appropriate if the group is very integrated in such way that both the parent (in Country A) and the subsidiary (in Country B) contribute substantially to the sales activities. Applying a mechanical generic rule to deal with the "no-where sales" issue is bound to produce inappropriate and arbitrary results.

The "no-where sales" issue can also occur if the group makes sales to a third country not participating in the FA regime. The analysis is basically the same as above, except that in this case it would not be acceptable to the bloc, at least politically, to allocate any tax base to the third country. The issue can be more problematic if the sales income to the third country is also subject to tax in the third country. The question of whether the group can avoid double taxation is explored in Section C.2.7.1 below.

C.2 Complexity

The complexity of the CCCTB regime, as an example of a multilateral FA model, arises primarily from several sources:

(1) number of taxpayers affected;
(2) definition of a "group";
(3) definition of "tax base";
(4) apportionment formula;
(5) transitions between separate entity doctrine and enterprise doctrine;
(6) interactions between the two doctrines; and
(7) international issues.

Each of these sources is analysed in the following paragraphs.
C.2.1 Number of taxpayers affected
This issue is analysed in Chapter 11 Section 11.5.3.1.

C.2.2 Definition of a “group”
Issues of the definition of a group include:

1. sandwich structure;
2. ownership threshold;
3. entities eligible to join the CCCTB regime; and
4. unitary vs multiple businesses.

C.2.2.1 Sandwich structure
This issue is discussed in Chapter 11 Section 11.5.3.2(1).

C.2.2.2 Ownership threshold
The issue of the threshold percentage is discussed in Chapter 11 Section 11.5.2(2). The following materials analyse other issues with respect to the ownership threshold.

(1) Percentage of what?
Definition of a “group” should be based on the concept of “control” under the enterprise doctrine. “Control” may be defined in terms of a number of alternative factors, including voting rights, rights to receive dividend and/or capital distribution. The current EC position is a definition based on voting rights, which “were considered to be the best measure of control”. 29

29 WP59, paragraph 34. It is interesting to note that the EC position is not consistent with existing EC directives (namely, Parent/Subsidiary and Interest & Royalties directives) which adopts “ownership of capital” as the general definition of a “group”: WP48, paragraph 6. The EC tried to justify the inconsistency by arguing that “unlike these directives the CCCTB is being designed as a comprehensive measure, is not complementary to existing tax measures
However, this is a controversial issue in practice. Experience shows that the definition would require specific anti-avoidance measures (for example, rules to deal with options and convertible securities) to deal with abuses. Some also argue that "economic rights (i.e., participation in the equity of a company) would ... be a much easier element to assess [than voting rights]."  

(2) Minority interest

If the threshold is substantially below 100 per cent, minority interest may be an issue. Some countries currently allow intra-group compensation to be paid for the use of losses under their consolidation regimes. The rationale of the policy is to compensate the company for the effective transfer of losses to the parent company.

The current EC position is not to compensate minority shareholders, because "there is also scope for the minority interest to benefit [from the CCCTB regime], for example if the subsidiary's tax base is reduced by the use of losses from other group companies."  

However, the minority interest issue may be more significant if the threshold is set at a low level (say 50.1%), or the ownership test through a company chain is considered at each level separately. This leads to the next problem: indirect control.

... and not only to avoid double taxation of some specific items of income": ibid. Regardless of whether the argument justifies the use of different factors in the definitions, it highlights the difficulties of designing a proper definition of a "group" in practice. For a discussion of the concept of "control" in consolidation regimes, see Chapter 5 Section 5.5.

30 WP59, paragraph 33.
31 WP48, paragraph 48.
32 For example, if the threshold is set at 75%, and parent company owns 75% of Company B, which owns 75% of Company C, which in turn owns 75% of Company D, the parent
(3) Indirect control
An issue is how should the definition of a “group” deal with multiple tiers of companies. For example, assume the threshold is set at 75 per cent, and parent company A owns 75 per cent of Company B, which in turn owns 75 per cent of Company C. One approach is to multiply the ownership interest, that is, A is regarded as owning 56 per cent (75% x 75%) of C, meaning that C can not join the consolidated group. Alternatively, in counting the ownership of A in C, A is deemed to own 100 per cent of B – as A is regarded as “controlling” B under the definition of a “group” – and C is thus eligible to join the consolidated group.

The advantages and disadvantages of these two approaches are discussed in Chapter 5 Section 5.5 in detail. For the present purpose, it should be noted that the “deemed 100%” approach would represent a stronger application of the enterprise doctrine, provided the definition of a “group” is properly based on the concept of “control”.

As the EC is eager to include as many companies as possible in the CCCTB regime, the current EC position is to adopt the second approach. Its rationale for the approach is that it “ensures that all subsidiaries in which the parent controls directly or indirectly 75 per cent of the voting rights are included in the consolidation. Without this a chain held at 75 per cent through a number of tiers would fragment into a number of overlapping groups”.33

33 WP57, paragraph 89. An additional “indirect control” rule proposed by the EC is that any holding of 50% or less in the company chain would count as zero. The purpose of this rule is to ensure that all companies included in consolidation are “controlled” by the parent company: ibid, paragraph 89-90.
The main issues regarding the ownership threshold are summarised below:

**Table 14 Issues of alternative ownership thresholds**

<table>
<thead>
<tr>
<th>Issues</th>
<th>Threshold</th>
<th>50%</th>
<th>75%</th>
<th>100%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Control</td>
<td></td>
<td>X</td>
<td>✓</td>
<td>✓✓</td>
</tr>
<tr>
<td>Protecting “all in” rule</td>
<td></td>
<td>✓✓</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>Minimising transfer pricing</td>
<td></td>
<td>✓✓</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>Minority interest issue</td>
<td></td>
<td>X</td>
<td>✓</td>
<td>✓✓</td>
</tr>
</tbody>
</table>

*Key: ✓✓ - best; ✓ - good; X - worst*

The enterprise doctrine requires that the threshold should be set at a level to ensure “control” of the parent company on its subsidiaries included in a group as the taxable unit. The “100%” threshold would in general represent full control, thus is better in this respect than a threshold of “75%”. A “50%” threshold would be regarded as the least favourable on the issue of “control”. The minority interest issue has similar relationship with the threshold.

In contrast, a “50%” threshold would be better than a “100%” threshold in respect of its effectiveness of protecting the “all in” rule. In general, the “all in” rule is designed to minimise tax avoidance from “cherry-picking” which subsidiaries to include in a group taxation regime. Effectiveness of the “all in” rule would be compromised if the threshold is set at say “100%”. This is because a group can circumvent the “all in” rule by reducing its holding in a subsidiary to say 99 per cent, though still maintain in practice full control over the subsidiary. Therefore, a lower threshold is more effective as an integrity
measure. The level of threshold has similar effect on the effectiveness of a regime to minimise transfer pricing manipulations.

**C.2.2.3 Entities eligible to join the CCCTB regime**

Member States in the EU have different definitions of entities subject to corporate taxation. An issue of the CCCTB regime is whether it should have a specific definition of entities eligible to join the regime, or adopt the Member States’ domestic definitions.

The basic position of the EC at present is to rely on existing definitions of Member States, namely to include entities that are subject to corporate taxation in a Member State.\(^{34}\)

Other issues relating to types of entities eligible to join CCCTB regime include:

1. **Special entities**
   Special rules may be required to deal with various financial entities, such as credit institutions, insurance undertakings, collective investment vehicles, pension funds and venture capital institutions.\(^ {35}\)

2. **Transparent entities**
   Issues involving transparent entities (for example, partnerships) can be complex. The general consensus seems to be that they should not be included in the scope of CCCTB; instead the owners of the entities (for example, the

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\(^{34}\) In particular, the EC proposes that eligible entities would be included in a list (to be updated annually), including both EU companies and non-EU companies (which have a similar form to EU companies) that are subject to Member State’s corporate income tax: WP57, paragraph 10.

\(^{35}\) European Commission, “Progress to date and future plans for the CCCTB” (CCCTB\WP\046, CCCTB WG, 2006) (“WP46”), paragraph 37.
partners of a partnership) should be included if they are eligible entities.\textsuperscript{36} However, the issue becomes more complex if the entity is transparent in one Member State and opaque in another. The EC proposes a “mutual recognition principle” under which the interpretation by the Member State where the entity is a resident prevails.\textsuperscript{37} However, the issue is controversial and not settled.\textsuperscript{38}

Related issues include whether or not the presence of such entities in a group structure would break the ownership chain, and the impact of such entities to the apportionment formula (for example, percentage of the factors of such entities to be included in the formula).\textsuperscript{39}

**C.2.2.4 Unitary vs multiple businesses**

An issue related to the definition of a “group” is whether it should be restricted to group members that are engaged in a unitary business, or include all members as long as they are under the common control of the parent company.

Theoretically, if a parent company “controls” its subsidiaries, logically the subsidiaries should be regarded as an extension of the parent, and can carry out activities only according to the direction of the parent. It follows that any business carried on by the subsidiaries should be regarded as part of the business of the parent. In other words, the concept of “control” dictates that any business carried on by subsidiaries necessarily forms part of the business of the group.

\textsuperscript{36} WP59, paragraph 17.

\textsuperscript{37} Ibid, paragraph 19.

\textsuperscript{38} For suggestions of different policies to deal with such entities, see ibid, paragraphs 19-21.

\textsuperscript{39} WP53, paragraph 20.
If this logic is accepted, the definition of a “group” should not be restricted to a unitary business. Provided subsidiaries are under common control of the parent company, different businesses carried on by the subsidiaries constitute the overall business of the group. Therefore, the definition of a “group” should be based on the concept of “control”, and not on business lines.

Historically, the discussion of this issue has been influenced by the experience in the U.S. states which adopt a unitary business definition in their formulary apportionment approach to compute state income tax on corporations. For instance, a proposal had been made to apply a group-bloc model to NAFTA region, adopting a unitary business definition for a “group”.40 Besides the theoretical problem of a unitary business definition as discussed above, in practice such a definition imposes serious challenges and problems. Experience in both the U.S. and Germany shows that policing the definition of a unitary business is very difficult in practice. Even proponents of a “unitary business” model admitted that “it is unlikely that a definition of a unitary business can be developed that would solve all cases”.41 Germany has since removed the requirement of unitary business or “economic integration” in its group taxation regime.42

A definition of a “group” covering multiple business lines poses an inevitable dilemma to a cross-border group taxation model that employs a formulary apportionment approach. Under a FA method, the tax base of a group is in general allocated to jurisdictions according to a pre-determined formula. That formula would apply to the tax base of a group even if it carries on multiple

40 McDaniel, above note 7, at 706.
41 Ibid, at 711.
business lines. It is doubtful if the formula – being applied to different business lines with possibly different income-generating factors and weightings attached to each factor – would produce a fair and proper allocation.43

C.2.3 Definition of “tax base”
A cross-border FA regime requires a common definition of tax base for a group. Problems arising from this issue that in general make the regime more complex include the followings:

C.2.3.1 Conflicts between Member States
Under a FA method, a country can get its share of tax revenue in two ways: (1) share of the group’s common tax base; and (2) taxes other than corporate income tax imposed directly on group companies resident in the country. The conflict of interest arises as the latter – assuming deductible in the calculation of the common tax base – reduces the pool available for sharing with other countries. In other words, if a country is allowed to charge a tax which is deductible under the FA regime, other countries may be disadvantaged as they would share a smaller tax base.

This issue was debated in depth in the CCCTB working group.44 For instance, taxes may be charged on production factors such as payroll or property. Deduction of these taxes within a single jurisdiction under a domestic tax regime is acceptable as the tax revenue stays within the country. However, the issue becomes more sensitive and controversial for a multilateral system.

43 For example, the relationship between FA method and unitary business requirement has been criticised: a “broad definition [of a group to cover multiple business lines] would significantly distort economic reality by combining different businesses with widely different profit margins and apportionment factors, while a narrow definition would foster litigation over the scope of inclusion”: Brown, above note 11, at 762.

44 WP46, paragraphs 10 & 11.
Solutions suggested include: (1) no deduction for such taxes; or (2) deduction allowed only after apportionment of tax base.\textsuperscript{45}

Another example illustrating the potential conflict between jurisdictions in the definition of a common tax base is the different deduction rules for specific items, such as bad debts and insurance company provisions. Alternative policies include harmonising the rules, and mutual recognition of domestic rules.\textsuperscript{46}

Mutual recognition of domestic rules would be a simpler approach. However, given the conflict of interest issue, the FA method should have a standardised set of rules for all Member States.

Some Member States, for example, France and Denmark, have a territorial income tax system.\textsuperscript{47} It is difficult to decide how they should be incorporated into the CCCTB regime, which most likely would be based on a typical residence and source system (that is, residents are taxed on worldwide income while non-residents are taxed only on income sourced in the country). The EC is concerned that as “territorial system represents a fundamental element of their fiscal policy ... a system that presupposes an obligatory switch to [worldwide taxation] might limit the number of Member States interested in joining the CCCTB”.\textsuperscript{48} In summary, defining a common tax base that is

\textsuperscript{45} WP46, paragraph 11. No specific further discussions on this issue seemed to have taken place, but the current position of the EC appears to be that there is no specific disallowance of such taxes: European Commission, “CCCTB: possible elements of a technical outline” (CCCTB\WP\057, CCCTB WG, 2007) (“WP57”), paragraphs 24 & 25.

\textsuperscript{46} WP46, paragraph 41.

\textsuperscript{47} European Commission, “International aspects in the CCCTB” (CCCTB\WP\019, CCCTB WG, 2005), paragraph 14.

\textsuperscript{48} WP46, paragraph 21.
acceptable to all jurisdictions concerned is a very complicated and controversial task.

**C.2.3.2 Conflict between industries**

Industries may prefer to have specific rules that conflict with each other. For instance, on the valuation of financial assets held by financial institutions, it appeared in the CCCTB discussions that banks would favour market value, but insurance undertakings would favour historical costs. If different rules are required for different industries, the definition of tax base would become more complex.

**C.2.3.3 Unitary business?**

Another issue on the definition of tax base is whether the definition should be restricted to profit or loss from a unitary business. The issue arises because most proposals of the FA method are based on the U.S. model, which applies the unitary business principle.

The U.S. states’ FA regimes typically apply the unitary business principle, which is a familiar concept in state taxation for more than 50 years. Under the principle, only income from a unitary business would be apportioned. The principle has its roots in state real property tax law. The U.S. experience suggests that the application of the principle in practice is very problematic, as “[a]lmost overwhelming problems exist in attempting to define with any degree of precision what constitutes a unitary business” (emphasis added).

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49 WP46, paragraph 38.
50 The discussion on the U.S. states’ unitary business principle here is based on: Coffill & Willson Jr, above note 1, at 1113 & 1114.
51 Ibid, at 1114.
The EC has wisely avoided this complex issue and does not propose a unitary business approach.

**C.2.3.4 Water’s edge limitation?**

Under the enterprise doctrine, the FA method adopted by a bloc in theory may still be based on the “worldwide” profits of the group – that is, including profits and losses of subsidiaries outside the bloc. The bloc can then calculate its share of the tax base according to the allocation formula. This represents a more faithful application of the enterprise doctrine, as the “whole” group is regarded as a single enterprise.

This “worldwide” tax base approach has two major problems. First, politically it is most likely unacceptable to countries outside the bloc, as the regime appears to be a blatant competition for tax base. Second, the approach is at odds with the international tax norms – which is premised on the separate entity doctrine – and can create double or no taxation. To make it worse, the double or no taxation is difficult to resolve as it is created by two different taxation systems which existing tax treaties are not designed to resolve.

Because of these concerns, the EC proposes that the CCCTB regime would include only group companies resident in the EU. This water’s edge limitation is not supported by the enterprise doctrine, but is possibly a “wise, and perhaps necessary” compromise.

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52 The famous history of the Californian “worldwide” FA regime and its eventual doom is a telling example: see for example McIntyre, above note 9, at 944.

53 The regime would also include PE in the EU: WP57, paragraph 85. The proposal for a FA regime for NAFTZ also adopted the water’s edge limitation: McDaniel, above note 7, at 726-727.

54 McDaniel, ibid, at 727.
C.2.3.5 International financial reporting standards ("IFRS")

Some proponents of the FA method may suggest that the worldwide convergence of IFRS would reduce complexity of the definition of a common tax base. However, the IFRS is at best just a starting point. For instance, the EC has always stressed that "it is not possible to make a formal link between the [tax] base and ... IFRS". The reason is that IFRS is not universally adopted in the EU or for all companies.

This means that under the CCCTB regimes, most companies would have to start with accounts prepared under domestic national accounting rules, and then make necessary adjustments to satisfy the CCCTB rules and definitions in arriving at the common tax base. However, concerns were raised that, first, the need for 27 different 'bridges' between the national accounting rules and the CCCTB rules "would not bring about the simplification ... which it is supposed to". Second, the CCCTB rules and definitions may not cover every possible situation. The question is what will happen then. The EC suggested "defaulting back to the national tax treatment". The problem of relying on the 27 different national sets of accounting rules is obvious: inconsistency. This not only is counter to the objective of a common tax base throughout the EU, but also increases the complexity of the tax regime.

55 WP57, paragraph 9.
56 For example, many Member States do not permit the use of IFRS for individual company accounts and not all IFRS are considered suitable for tax purposes: ibid.
57 Ibid.
58 WP59, paragraph 20.
59 European Commission, "Summary record by the chair of the meeting of the common consolidated corporate tax base working group" (CCCTB/WP64, CCCTB WG, 2008) ("WP64"), paragraph 13.
C.2.4 Apportionment formula

The design of the apportionment formula is possibly the most controversial and complex issue in a multilateral FA model. The formula serves to allocate tax base to jurisdictions which may have conflict of interests and may have different interpretation of a “fair” allocation. The following paragraphs summarise some major issues of the formula, which can be classified into two broad categories: (i) scope of the formula; and (ii) technical design of the formula.

C.2.4.1 Scope of the formula

A fundamental issue about the formula is its scope of application. Questions include whether the formula should be applicable to all types of income or just active business income; and whether a single general formula should be applicable to all industries. The inherent problem of a FA method is hidden behind the deceptively simple concept of allocating the tax base by a single formula. Applying a single formula to all types of income and businesses effectively ignores the economic reality of:

(1) different types of income, which is generated by different income-generating factors;
(2) different types of industries, which have different income-generating factors and different weightings; and
(3) different business models of individual groups, which again may have different factors and weightings.

A general formula applying to all groups is bound to be arbitrary and detach from economic reality. In contrast, the profit-split method under the OECD transfer pricing guidelines is tailored-made to fit a particular group in terms of the types of income, industry and any specific business models. The method
is therefore more likely to produce a fairer allocation of the tax base to jurisdictions.

It is widely accepted that it is not possible to have only one formula applying to all industries.\textsuperscript{60} The deviation from the ideal “one formula fits all” scenario inevitably increases the complexity of the FA method. The complexity arises not only from multiple formulae, but also from the existence of multiple-business groups. Such groups would have to apply different formulae for their respective business lines. Arm’s length accounting – which is one of the devils that the FA method is claimed to conquer – would be required to determine the profit or loss of each business line within the groups.\textsuperscript{61} In that case, it is possible that “multinationals would be subject both to extensive application of arm’s length rules and formulary apportionment within [the bloc]”.\textsuperscript{62}

\textbf{C.2.4.2 Technical design of the formula}

The design of the formula involves complex and often controversial issues, including:

1. the “nexus” issue;
2. number of factors in the formula;
3. choice of factors;
4. definition of each factor; and
5. weighting attached to each factor.

\textsuperscript{60} This is the position of all US experts that participated in one of the EC meetings on CCCTB: WP64, paragraph 46. Industries for which specific formulae have been developed include financial institutions, transportation, communications, oil and gas pipelines and professional sports: McDaniel, above note 7, at 710-711.

\textsuperscript{61} This is the reason why the number of industry-specific formulae should be kept to a minimum: McDaniel, ibid, at 711. However, economic reality of different industries with different income-generating factors dictates multiplication of formulae.

\textsuperscript{62} McDaniel, ibid, at 713.
These issues are analysed in the following materials.

C.2.4.2.1 "Nexus" issue

One of the basic issues to address before going into the detailed technical problems of the formula is the threshold or "nexus" issue, namely what should be the threshold that would trigger an allocation of tax base to a country. Alternative choices of nexus include:

(1) Presence of allocation factors

Theoretically, the presence of allocation factor(s) in a country indicates that the group has income-generating capacity there and thus should justify an allocation of the tax base to the country. In practice, the U.S. Multi-state Tax Commission has recommended this nexus test and some states in the U.S. have begun to apply it. However, this "nexus" test may be regarded as too drastic (for example, a group may be subject to tax in a country simply due to the fact that it has sales in that country, even though it has no PE/subsidiary there) and "not in line with OECD principles".

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63 The U.S. experts who were present in a meeting organised by the EC on CCCTB were particularly keen to the idea that the presence of sales in a country should justify allocation to the country, and challenged the relevance of the PE requirement in the 21st century: WP64, paragraph 53. It appears that the main driving force behind that argument was the fear that the "request for physical presence of a group to allocate profits by destination [would lead] to the risk for market States of losing a substantial part of the tax base": ibid.

64 WP56, paragraph 40.

65 For instance, the EC has described this nexus test as having "conceptual appeal ... [but] it may at this point of time be a step too far": ibid, at 12.

66 This is the main reason why the EC rejected this nexus test: WP60, paragraph 61. The position seems to be supported by the business sector: WP64, paragraph 54.
(2) Presence of subsidiary/permanent establishment
This is the current position of the EC, the main reason being in compliance with the OECD principles. However, this test has a technical problem, known as "no-where sales" issue. In essence, the issue is how to allocate tax base if a group has sales factor in a country where it does not have PE/subsidiary. The basic problem is that the resulting allocation would be arbitrary and detached from economic substance. This issue is discussed in more detail in Chapter 11 Section 11.5.2(7) and Section C.1.8 above.

Other possible nexus tests include "effectively connected with trade or business" concept, and "market penetration". These tests are not supported by the theory behind the FA method (namely the presence of income-generating factors), or the prevailing international tax principle in respect of PE. They do not gain much attention in the debate of the CCCTB project and is not explored further here.

C.2.4.2.2 Number of factors in the formula
A key question is how many factors should be included in the formula. Bearing in mind the basic objective of the formula is to allocate tax base according to "income-generating" factors located in each jurisdiction, the

67 WP60, paragraph 61.
68 Theoretically, the same problem may occur for payroll or asset factors too. However, in practice, the "sales by destination" factor is the most likely candidate to cause the problem.
69 The same problem arises if the sales are made to a country outside the bloc.
70 For discussion of the problems and the equally problematic alternative "solutions", see WP60, paragraphs 58-59.
71 For example, Paul McDaniel suggested this possibility in his proposal for NAFTA region, borrowing the concept from US tax law: McDaniel, above note 7, at 706-707.
72 This nexus test means that allocation of tax base would be made to a country if the group has achieved "gross receipt above a predetermined amount": Richard D Pomp, "Issues in the Design of Formulary Apportionment in the Context of NAFTA" (1994) Tax Law Review 795, at 813.
logical answer is that it should depend on the actual income generating activities of a particular corporate group in question. However, the precision of that approach must be sacrifice if the FA model prefers to have a single common formula that in general would be applied to all corporate groups. In other words, a general formula is bound to be arbitrary, resulting in inappropriate allocations.

Given this inherent problem of arbitrariness, proponents of the FA method nevertheless have suggested different number of factors in the formula. Some have suggested just one factor. Many have suggested three factors - payroll, asset and sales - which are the most common factors adopted in existing FA method used in the U.S. states. Some simply suggested that “[much] more sophisticated factors [than the three factors] need to be developed for today’s multinationals”.

The current EC position is that it prefers at least three factors. It believes that a multiple-factor formula would “create a robust, that is, not volatile apportionment mechanism … [as] the relocation of one unit of one of these factors would shift less than one unit of the tax base” (emphasis added).


74 See for example: McIntyre, above note 9, at 940-941. The EU experts in general accept that payroll and asset are important income-generating factors that should be included in the apportionment formula, but inclusion of the sales factor was much more controversial: for example, see European Commission, “An overview of the main issues that emerged during the discussion on the mechanism for sharing the CCCTB” (CCCTB WP052, CCCTB WG, 2007) (“WP52”), paragraphs 22, 31 & 39.

75 McDaniel, above note 7, at 708.

76 WP60, paragraph 10.

77 Ibid. The other reason given by the EC is that a multiple-factor formula would facilitate negotiation and agreement among countries on the definition and weighting of the factors: ibid.
The EC’s argument highlights again the inherent arbitrariness problem of the FA method. The formula should be designed and the factors should be carefully chosen to reflect as accurate as possible the generation of income of a group. However, the EC argues that it is an “advantage” if each factor is insignificant to the allocation of tax base. The argument is logically inconsistent with the underlying objective of the FA method.

C.2.4.2.3 Choice of factors
The EC has considered mainly three alternative choices of factors - macro-factors (for example, GDP of a country); value added; and traditional micro-factors such as sales and payroll – and finds that all of them are problematic.\(^78\)

Macro-based formula has the advantages of being simple and immune from manipulation (for example, GDP of a country is in general out of control of corporate groups). The critical disadvantage is that its allocation would be virtually disconnected with the economic reality of the group. Most countries would regard such an allocation as unacceptably unfair.\(^79\)

The value added approach is less arbitrary than a macro-based formula and has the advantage of being applicable to all industries.\(^80\) However, it suffers from many problems, including complex and confusing concepts, failure to remove/reduce transfer pricing problems, and the avoidance opportunity for “value shifting”.\(^81\)

\(^78\) WP59, paragraph 9-19.
\(^79\) WP52, paragraphs 9-10.

\(^80\) In comparison, the traditional micro-based approach (for example, sales, asset and payroll) requires industry-specific formulae to deal with the special situations of particular industries, such as financial institutions.

\(^81\) WP52, paragraphs 15-19.
The traditional micro-based approach is the current preferred choice of the EC. However, the EC’s position is ambiguous, as it states that it intends “to put the macro-based approach and the [value added approach] in a ‘stand by’ position – without definitely excluding these possibilities as a mechanism to share the consolidated tax base” (emphasis added). 

In fact, the EC has left open the possibility of a “hybrid” formula, which combines both macro and micro factors. For example, “introducing a macro-factor into a micro-based apportionment could combine the advantage of the fairer sharing attained by micro-factors ... with some added stability to the mechanism ...”. However, it is unclear if the “hybrid” would compound the problems and complexity of the FA method.

In summary, the alternative factors represent a spectrum of choices as depicted in 38 below:

**Diagram 38 Alternative choices of factors in FA allocation formula**

![Diagram 38](image)

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82 WP60, paragraph 9. For detailed discussions of the three alternatives and the reasons for the EC’s preference, see for example WP52, Sections II & III.

83 WP52, at 11.

84 Ibid, paragraph 48.
No one single approach is perfect. Discussions of the CCCTB WG clearly indicate that the issue is very complex and controversial, as each of the approaches has their fair share of problems. The optimum choice would likely to be a compromise between conflicting policy objectives.

C.2.4.2.4 Definition of each factor
The EC states that the design principles of the CCCTB sharing mechanism are:

- as simple as possible;
- difficult to manipulate;
- fair and equitable distribution of tax base; and
- not lead to undesirable tax competition.

Unfortunately, these are exactly the major challenges of a FA method, which have proved to be difficult to overcome in practice. The definition of each allocation factor in the formula illustrates the challenges well.

C.2.4.2.4.1 Sales factor
Each allocation factor has three main variables: definition, location and valuation. Discussions of the factors are structured accordingly.

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85 See for example WP59, paragraphs 10-29.
86 An EC taxation paper came to basically the same conclusion without any specific recommendation, except the comment that “there is no such thing as a ‘perfect’ mechanism”: Ana Agundez-Garcia, The Delineation and Apportionment of an EU Consolidated Tax Base for Multi-Jurisdictional Corporate Income Taxation: A Review of Issues and Options (European Commission Taxation Paper, 2006, EC, Luxembourg), at 86-87. The preferred approach of the EC is the typical micro-factor formulary apportionment: WP60, paragraph 9.
87 WP60, paragraph 8.
(a) Definition of sales factor

The sales factor is the most controversial among the three typical factors (namely, sales, payroll and asset). Issues include:

(i) Should it be a factor at all?

This is the fundamental issue that makes the sales factor the most controversial factor. The EC supports the inclusion of the sales factor primarily for two reasons. First, the sales factor is an income-generating factor on the demand side, as "sales could be seen as a reasonable apportioning factor since companies make profits only insofar as their output is sold". Second, the EC relies on the experience in the U.S. and Canada where "sales are currently used in formulary apportionment systems of the [two countries] and no plans seem to exist for changing this fact".

Interestingly, the EC does not seem to be very confident about its own position. While showing preference for inclusion of a sales factor, it commented that "the idea that demand creates profits seems

88 For example, see WP56, paragraph 25.
89 WP60, paragraph 43.
90 Ibid. This position was strongly supported by U.S. experts who posed this challenge: "try to make profits if you cannot sell anything": WP64, paragraph 48.
91 WP60, paragraph 43. In contrast to many EU experts, experts from the U.S. who were invited to advise the EC were clearly in support of the inclusion of the sales factor: WP64, paragraph 46. Another reason put forward by the U.S. experts in support of a sales factor is that "it is more difficult for companies to manipulate their markets": ibid. The emphasis on the sales factor in the U.S. is due to two main reasons: (1) implicit tax on the factors: the factor choice has significant effect on the actual economic activities in a state, which understandably would be reluctant to place more emphasis on the asset and payroll factors; and (2) anti-avoidance concern: it did not take long for the U.S. states to realise that factors of production are more mobile than markets: Julie Roin, "Can the Income Tax be Saved? The Promise and Pitfalls of Adopting Worldwide Formulary Apportionment" (2008) 61(Spring) Tax Law Review 169, at 203.
unsustainable when the company lacks other types of taxing nexus in the
destination state ....” (emphasis added). The EC was basically
cconcerned that a PE was necessary before tax base could be allocated to
a country. Otherwise, the FA regime would not be consistent with the
OECD model convention.

Many experts in the EC disagreed with the “demand side income-
generating factor” argument. They argued that sales should not be a
factor at all. On one hand, a “sales by origin” factor would simply
duplicate the other two factors, namely payroll and asset. On the other
hand, a “sales by destination” factor in the apportionment formula would
be an inconsistent concept to the current international tax regime, under
which in general the source country does not have a taxing right on the
sales profits unless a taxpayer has a permanent establishment in the
country. Furthermore, some EU experts argued that a sales by
destination factor would compensate “consuming states via corporate
taxation [and] would duplicate the effect of the Value Added Tax in the
EU”.

The last point highlights that the EC should be careful in adopting the
U.S. or Canadian models. The situations in the two countries are not the
same as in the EC. For instance, the U.S. does not have a VAT system

92 WP52, paragraph 50.
93 The EU businesses seemed to share this concern: WP64, paragraph 54.
94 A “sales by origin” factor implies that tax base would be allocated to the country of origin
of the sales. Alternatively, a sales factor may be by destination, meaning that the tax base
would be allocated to the source country. Even among supporters of including the sales
factor, the two alternatives also caused intense debates in the EC, and will be discussed in
more detail below. For the present purpose, it should be noted that the current preference of
the EC is the “sales by destination” factor.
95 WP52, paragraph 39.
96 Ibid.
similar to that in the EC. The U.S. states and Canadian provinces do not individually enter into income tax treaties. Moreover, and perhaps more importantly, the U.S. and Canadian models are not cross-border regimes. They are regimes for sub-federal levels and do not serve to share tax base between jurisdictions. A “sales by destination” factor may serve both countries well, as both are developed countries and substantial importers. However, the CCCTB regime would have to consider the interests and concerns of up to 27 countries, including both net importers and exporters. A “sales by destination” factor may have “negative effects towards ‘smaller’ economies compared to ‘larger’ economies [as] on average ‘small open economies’ tend to export more than they import ...”.

(ii) sales by origin or destination?
If it is accepted that “sales” should be a factor in the allocation formula, a difficult question that follows is whether the sales should be measured at origin or destination. The choice would have very significant implications on the share of tax base by each jurisdiction.

Both alternatives have problems and the choice between them is highly controversial. On one hand, sales by origin “replicates the distribution [of tax base] already covered by payroll and [asset factors]” while sales...
by destination is inconsistent with treaties\textsuperscript{100} and would duplicate the effect of VAT in the EU.\textsuperscript{101} On the other hand, “sales by destination” is inconsistent with the “function of corporate taxation [which] is to tax production and not consumption”.\textsuperscript{102}

The issue is also political, as sales by destination tend to favour large countries, as “small countries with a limited demand ... would be worse off compared to large countries with a significant internal demand ...”.\textsuperscript{103} The political nature of the emphasis on “sales” factor is well supported by the U.S. states experience. In particular, it has been observed that many states have increased the weight of the sales factor, as “it enables the state to ‘tax the other guy’ [that is, out-of-state taxpayers who make sales into the state] while at the same time purporting to create a friendly business climate and to promote economic development within the state”.\textsuperscript{104}

Another problem with a “sales by destination” factor is that it is unlikely to be acceptable to “natural resource-exporting” countries. These countries currently have in general the taxing rights over their natural resources,\textsuperscript{105} and it is difficult to see why they would be willing to give up those rights.\textsuperscript{106}

\par\textsuperscript{100} See for example WP64, paragraph 47.
\par\textsuperscript{101} WP52, paragraph 39.
\par\textsuperscript{102} WP56, paragraph 32.
\par\textsuperscript{103} WP52, paragraph 43.
\par\textsuperscript{104} Coffill & Willson Jr, above note 1, at 1106.
\par\textsuperscript{105} For example, in the EU, it was reported that “at least 90% of the profit [from natural resources] is [taxed] on a source basis”: WP64, paragraph 57.
\par\textsuperscript{106} On this point, it is interesting to observe that the U.S. states which continue to place emphasis on payroll and asset factors “tend to be natural resource rich states, which do not have to worry about business relocations”: Roin, above note 91, at 204.
Moreover, both alternatives are subject to manipulation, which is a major concern for the EC.\textsuperscript{107}

(iii) Scope

The EC suggested that the following items should be excluded from the sales factor:

- exempt income;
- extraordinary income; and
- passive income, such as dividends, interest and royalties, unless it represents ordinary business income.\textsuperscript{108}

It may be reasonable to exclude exempt income from the factor, as exempt income is excluded from the tax base to be allocated. However, it is not clear why extraordinary income is excluded from the factor, as that income is included in the tax base.

Passive income is excluded from the sales factor primarily as an anti-avoidance measure against “factor shifting”.\textsuperscript{109} The fear is that such income is mobile and may be shifted to other jurisdictions to achieve artificial allocation of tax base. The exclusion from the sales factor is

\textsuperscript{107} For example, sales by origin “could be manipulated … since group companies could simply choose the place of their establishment [for shipment to their customers] and therefore the origin of sales”: WP64, paragraph 58. Sales by destination may be manipulated by routing the sales through an independent distributor in a particular country, while sales by origin may be manipulated by choosing the group company that makes the sales: ibid, paragraphs 50 & 58. See also WP52, paragraph 45.

\textsuperscript{108} WP60, paragraph 50.

\textsuperscript{109} Ibid, paragraph 51.
however inconsistent with the suggestion that passive income would be included in the tax base to be apportioned among jurisdictions.

(iv) intra-group sales
In contrast to the treatment of passive income, intra-group sales were suggested to be excluded from the tax base, but to be included in the sales factor.\textsuperscript{110} The main reason for the inclusion is that, if intra-group sales are excluded from the factor, group companies producing goods – thus generating substantial value added to the group – for intra-group sales would receive no tax base on account of the sales factor. In other words, a sales factor excluding intra-group sales would allocate tax base only to group members that make sales to third parties. The EC position may be influenced by political concerns, as “the current tax base distribution within a group composed of, for example, a manufacturing company, a distribution company and a marketing company would be completely changed within a formulary system compared to the current situation” (emphasis added).\textsuperscript{111}

It is unclear if the argument is valid. First, the country in which the manufacturing company is located would receive allocation of tax base under payroll and asset factors. Second, the inclusion of intra-group sales would create “factor-shifting” opportunities. For instance, tax base may be artificially allocated to a country, if a group sets up a subsidiary there to effectuate intra-group sales.

\textsuperscript{110} The EC originally appeared to prefer excluding intra-group sales from the factor, but seemed to have changed its mind: WP56, paragraph 29.

\textsuperscript{111} WP52, paragraph 40.
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(b) Location of sales factor

The EC suggested that the location of the sales factor should be determined on the destination basis, that is, to the group member located in the country where the sales to third parties occur. Problems of determining the location of sales include the followings:

(i) Complex rules

The location rules can be complicated. For instance, sales of movable property were suggested to be located in the country where the goods are “physically delivered”. The EC believes that such location rule would prevent manipulations through say billing address. Sales of immovable property would be located in the country where the property is situated.

The issue is more complex for sales of intangibles. Possible alternative location rules – all of them have been proved to be difficult to apply in practice – include: (a) where the intangible is used; (b) where the intangible is created; and (c) where the “income producing activities” are performed. The EC appeared to be silent on this point, unless sales of intangibles are regarded as “extraordinary income” which is specifically excluded from the scope of the sales factor. In any case, actual application of any one of the above alternative location rules in practice will not be easy.

112 WP60, paragraph 53. The existing VAT rules on the location where goods and services are deemed to have been supplied were suggested “as a starting point”: ibid, paragraph 54.

113 Ibid, paragraph 55.

114 Brown, above note 11, at 766; and Wilkins & Gideon, above note 1, at 1264.

115 WP60, paragraph 50.
Special rules are required for particular industries. For instance, transport services, for example, ferries, could be located where the transport begins or ends.

Provision of services was also suggested to be located by destination basis. For example, services provided would be in general located in the country where the services are actually enjoyed or used.\(^{116}\) Electronically supplied services may pose challenges to the location rule in practice, but the EC seems to be confident that the location could be easily determined by reference to the country "where the consumer is established".\(^ {117}\)

(ii) "no-where" sales
Another problematic issue with respect to the sales factor is "no-where" sales. The issue has been discussed in detail in Chapter 11 Section 11.5.2(7) and Section C.1.8 above. In summary, the main problems include whether the country where the sales are located should have a taxing right on its share of tax base under the FA regime, and if so, who should be the taxpayer. If not, where should the location of that sale be? The issue highlights that the FA method is arbitrary and can be very complex in practice.

(iii) Taxpayer(s) in "sales country"
An issue similar to the "no-where sales" issue arises if sales are made to a country where there are more than one group members. In that case, the question is who should be the taxpayer, and whether the answer will

\(^{116}\) Ibid, paragraph 56.

\(^{117}\) Ibid.
be different if none of those group members is involved in the sales activities.\textsuperscript{118}

The question would not be difficult to answer if the enterprise doctrine is applied consistently. Under the doctrine, a group is treated as one single enterprise under the common control of the parent company. The group is so integrated that any group members in a country would be appropriate proxy as the taxpayer in that country. In other words, if a portion of its tax base is taxable in one country due to the sales by destination factor, any group member in that country would be an appropriate taxpayer on behalf of the group.

However, the EC seems to be reluctant to apply the enterprise doctrine in this way. Conflicts and tensions between the enterprise doctrine and the separate entity doctrine seem to hinder a proper resolution of the issue. In particular, the EC found it difficult to accept that a group member – without any involvement in the sales – would have to be the taxpayer for that sales income.\textsuperscript{119} The complexity arising from the interaction between the two doctrines is discussed in more detail in Section C.2.6 below.

(iv) Prone to manipulation
The location of sales is prone to manipulation. Sales by origin may be manipulated by shifting the sales to third parties from one subsidiary to the other. Sales by destination can also be manipulated by assigning a distributor in one country instead of another. Various measures were

\textsuperscript{118} This issue was raised in one of the discussions of the EC on the allocation formula: WP56, paragraph 36.

\textsuperscript{119} Ibid.
suggested to counter such manipulations, thus making the regime more complicated. 120

(c) Valuation of sales factor
The main issue on valuation of the sales factor is whether it should be measured on a gross or net basis. For example, a group derives income from both securities trading and commissions. If a strict gross basis is adopted, the “sales” from securities trading would likely overwhelm the commissions. It will be a different story if a net basis is adopted.

In principle, a consistent basis should be adopted; comparing a net sales figure with a gross sales figure is inappropriate. However, it appears that even active proponents of the FA method have not come up with a consistent theoretically sound solution. 121 Experience in the U.S. states suggests that in practice they do compare “apples with oranges”, that is, they do not make adjustments to the sales numbers, unless in case of abuse. 122

It appears that the EC has not considered this issue in detail. It suggested that “the figure to take into account is the one taken into account for the purpose of calculating the tax base ...” 123 If it implies the gross basis, the sales factor would bias towards sales from trading.

120 See for example ibid, paragraph 34.
121 For example, McIntyre did not suggest any in principle solution; instead he simply emphasised that theoretically, the basis – whether gross or net - should be “consistent”: McIntyre, above note 9, at 941.
122 Ibid.
123 WP60, paragraph 52.
C.2.4.2.4.2 Payroll factor

Complexity caused by the payroll factor is discussed below in the order of (a) definition; (b) location and (c) valuation.

(a) Definition of payroll factor

Definition of the payroll factor has the following problems:

(i) employee vs self-employed
Payroll factor should theoretically represent the income-generating power of a group's employees. In practice, it is difficult to distinguish between employees and self-employed. The cross-border nature of CCCTB makes the issue more complex. For instance, countries may have different definitions and interpretation of the meaning of "employee". This raises the question of which country's interpretation should prevail.

The current position of the Commission is that "all personnel employed by a given entity should be covered ... The definition of an employee should be based on domestic legislation of the MS where the employee works and should mutually be recognised among MSs..." (emphasis added). Application of the rule in practice can be complicated. For example, if an individual signed an employment contract with a German company and works in France, the rule suggests that the French definition of "employee" should be applicable under CCCTB. It has a number of problems. First, it is not clear if it is feasible to apply French definition of "employee" to a German contract. Second, what happens if the individual works in Italy in the following year? The question is whether the Italian definition of employee would have to be applied in

124 WP60, paragraph 22.
that year to determine whether the individual is an employee. Lack of a consistent definition of “employee” among Member States can create complex issues in the FA method.\(^{125}\)

The issue also gives rise to avoidance opportunity. The payroll factor may be manipulated by making “use of ‘formally’ self-employed workers ... who in reality operate as dependent employees ...”.\(^{126}\) The EC position would be a challenge to implement in practice, as it requires assessment on the complex issue of “dependent” employees.

(ii) temporary/interim staff

Another issue in the definition of the payroll factor is whether to include temporary staff hired from an interim staff agency. Some EU experts argued that including such staff would double count the payroll costs in both the taxpayer and the agency, if the staff is also included in the payroll factor of the agency that formally employ them.\(^{127}\) The concern did not seem to be shared by other experts. The EC position on this issue is to include interim staff in the payroll factor by “the ‘effective’ employer if [the] interim personnel provides the same services that would have normally been performed by the firm’s ‘ordinary’ employees”.\(^{128}\)

\(^{125}\) The EC recognised that “it would be extremely burdensome, and probably impossible ... to harmonise national legislation in order to reach a common definition of an employee”: WP56, paragraph 8.

\(^{126}\) WP52, paragraph 25.

\(^{127}\) WP56, paragraph 12.

\(^{128}\) WP60, paragraph 23.
(iii) outsourced services
It is controversial whether to include outsourced services in the payroll factor. Some EU experts argued that they should be included for the following reasons:

(1) similar income-generating factor
Outsourced services arguably provide similar income-generating power as a company’s own employees, as “the very nature of the contribution of labour services to the generation of income is alike, regardless of the legal status of the workers ...”.

(2) fairness
It would be unfair if “two equally profitable companies were assigned different tax bases depending on whether they outsource most of their labour services or employ their own workers”.

(3) avoidance opportunity
If outsourced services are excluded from the payroll factor, it would be easy for companies to manipulate the factor by outsourcing and thus achieve factor-shifting.

Other experts argued that outsourced services should be included only if they are related to the “core business” of a company.

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129 WP56, paragraph 10.
130 Ibid.
131 Ibid, paragraph 11. For more discussion on this avoidance opportunity, see Roin, above note 91, at 205.
The EC position is to exclude outsourced services from the payroll services, except for outsourcing between consolidated group members.\textsuperscript{132}

\textit{(b) Location of payroll factor}

The location of payroll factor may be determined according to different alternative rules. It may be located in the country (i) where the employee resides, (ii) where the employee is employed, or (iii) where the employee performs services. For example, an individual who is a resident of the UK is employed by a German company to work in France. This raises the questions of where the payroll on this individual should be located, and how disputes between countries on this issue should be resolved.

The location issue is important as it is prone to manipulation. For instance, the location of the payroll factor may be shifted to a particular country (for example, a low tax country) by the following ways:

(i) outsource of labour

If labour is outsourced to a group member, the payroll factor can be effectively shifted to the latter. The allocation of the group's tax base would then be "allocated to the 'wrong' company, and subsequently the consolidated tax base could be shared 'unfairly'."\textsuperscript{133}

(ii) secondment

Another way to shift payroll factor is to second employees from one group company to another. For instance, employees may be employed by a group company in a low tax country and then seconded to work for

\textsuperscript{132} WP60, paragraph 24.
\textsuperscript{133} WP52, paragraph 24.
group companies in high tax countries. As the employees are on the payroll of the low-taxed company, the payroll factor may be shifted to that country.\textsuperscript{134}

In response to the potential factor-shifting, the EC suggested that the location of the payroll factor should be "the place where the employees provide their services".\textsuperscript{135} For instance, if outsourced services are provided by members of the same consolidated group, the labour costs would be attributed to the entity where the employees actually work. There are problems with this position. First, continuous tracking of the location of services performed is complex. Second, the payroll factor may still be shifted if the employees are seconded or services outsourced to a group company outside the EU. For example, the payroll factor in a high tax country may be artificially reduced by outsourcing services to a group company not covered by the FA regime. This is an example of the problems created by the interaction between the FA model and the separate entity doctrine. These problems and the resulting complexity are discussed in more detail in Section C.2.6 below.

(c) Valuation of payroll factor

The key valuation issue of payroll factor is whether the amount of employee remuneration\textsuperscript{136} is sufficient by itself, or whether it should be adjusted by say the different levels of wages in different jurisdictions,\textsuperscript{137} and if so, how it should be adjusted.

\textsuperscript{134} WP52, paragraph 26.

\textsuperscript{135} WP60, paragraphs 24 & 27.

\textsuperscript{136} The EC suggested that the figure to take into account should be "the amount of remuneration that is taken into account as a deductible expense for the purpose of calculating the tax base, including fringe benefits, social contributions, stock options, etc": ibid, paragraph 25.

\textsuperscript{137} WP47, paragraph 15; WP52, paragraphs 28-30; and WP59, paragraph 54.
Some EC experts argued for adjustment “to take into account the lower average level of wages in some MS to avoid an unfair apportionment” (emphasis added). This issue is political, and not surprisingly, some member states objected to the suggested adjustments. In particular, some argued that as “high wage countries are high price countries, the price of the public services the administration has to provide is higher. Thus a formula including headcount might unfairly reduce their share of the consolidated profit ...” (emphasis added).

The EC’s position is somewhat ambiguous. On one hand, it refused to adopt such adjustment; but on the other hand, it suggested to include the “number of employees” — in addition to the amount of remuneration - in the payroll factor and recognised that this inclusion “has to some extent a similar effect”.

C.2.4.2.4.3 Asset factor
The asset factor is also very complex and is analysed below in the following order: (a) definition; (b) location and (c) valuation.

(a) Definition of asset factor
Problems with respect to the definition of the asset factor include:

(i) Intangibles
Intangibles raise significant definition issues in the asset factor. Theoretically, intangibles should be included in the asset factor, as they

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138 WP60, paragraph 26.
139 WP64, paragraph 60.
140 For the allocation formula suggested by the EC, see WP60, paragraph 12.
are "nowadays one of the potentially most important profit-generating factors". ¹⁴² However, they present serious valuation and location issues. ¹⁴³ For instance, if intangibles are included in the asset factor, they would "raise exactly the same valuation problems that have been so difficult to deal with in the context of arm’s length pricing" (emphasis added). ¹⁴⁴ Furthermore, being very mobile, they are prone to manipulation.

For these practical reasons, intangibles are typically excluded from the asset factor in the U.S. states' FA regimes. ¹⁴⁵ The EC also suggested excluding intangibles from the asset factor. ¹⁴⁶ This is despite the understanding that "an important income-generating factor would be disregarded, thus leading to a misattribution of tax base" (emphasis added). ¹⁴⁷

The EC tried to justify the exclusion by arguing that "intangible assets ... are already (partly) included indirectly in the apportionment formula via ... other factors: salaries of researchers ...; assets used for creating

¹⁴² WP47, paragraph 16. For instance, it has been estimated that intangibles such as product designs, know how, branding, etc. accounted for approximately 70% of the value of the top 150 US companies: Roin, above note 91, at 206.

¹⁴³ Intangibles can be very difficult to value, especially self-generated intangible assets. Location of intangibles can also be a challenge, especially when intangibles are created and/or used by the entire group: WP60, paragraph 33.

¹⁴⁴ Brown, above note 11, at 765. Similar observation was made by Coffill and Willson: Coffill & Willson Jr, above note 1, at 1108.

¹⁴⁵ McIntyre, above note 9, at 922. The US experts advising the EC also suggested that intangibles should be excluded from the asset factor: WP64, paragraphs 63 & 64.

¹⁴⁶ WP60, paragraph 30.

¹⁴⁷ Ibid, paragraph 34. Some had suggested other factors to capture the income-generating power of intangibles, for example, cost of research and development expenditures: McDaniel, above note 7, at 723. However, those factors did not attract much attention or serious consideration, and thus would not be discussed in detail.
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intangibles ..." (emphasis added). The argument has at least two problems. First, the EC conceded that even if its argument stands, part of the income-generating power of intangibles is still not presented in the formula. Second, it is doubtful if the argument is valid. For instance, an intangible may be created 20 years ago in country A, but the current research staff and equipment is located in country B. Using the current payroll and asset factors would produce inappropriate and arbitrary allocation with respect to the intangible.

In summary, the exclusion of intangibles from the asset factor is inconsistent with the fundamental principle of including all income-generating factors in the allocation formula. As income generated by the intangibles is included in the tax base, the resulting allocation is bound to be arbitrary. However, including the intangibles in the asset factor would increase the complexity of the FA regime.

(ii) Leased assets

It is controversial whether to include leased assets in the asset factor, as inclusion of such assets would distort economic decision of whether to lease or purchase assets. Experience in the U.S. is that leased assets are in general excluded from the asset factor except in abuse cases (for example, intra-group leased assets).

In contrast with the U.S. model, the EC suggested to include leased assets in the asset factor. It is not clear why this suggestion is

148 WP60, paragraph 34. US experts advising the EC made similar arguments: WP64, paragraph 65.
149 WP47, paragraph 16.
150 McIntyre, above note 9, at 940.
151 WP60, paragraphs 39 & 40.
inconsistent with its position on outsourced labour as discussed in Section C.2.4.2.4.2(a)(iii) above. It is also unclear if assets used by a contract manufacturer would be included or not.

An inter-related issue is whether the location of such assets should be at the location of the lessor or the lessee. This issue is discussed in more detail in the Section “Location of asset factor” below.

(iii) Financial assets
Due to their mobility and for avoidance concerns, the EC suggested excluding financial assets from the asset factor (except for financial industries). As discussed in Chapter 11 Section 11.5.2(5), the exclusion violates the fundamental principle of including all income-generating factors in the formula, and thus would produce arbitrary allocation. This criticism is especially valid as income generated by financial assets is included in the group’s tax base.

(iv) Trading stock
As discussed in Chapter 11 Section 11.5.2(5), for avoidance concerns, the EC also proposed to exclude trading stock from the asset factor, despite recognising that inventory “could represent a very important component of assets for certain sectors (for example, trading companies)”. The suggestion would not only produce arbitrary allocation, but is also inconsistent with the EC’s recommendation on financial assets. Both trading stock and financial assets are excluded from the asset factor due to their mobility and thus prone to factor-

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152 See for example, WP59, paragraphs 10 & 11.
153 Ibid, paragraph 11.
154 WP60, paragraph 31.
shifting.\textsuperscript{155} However, it is not clear why the EC did not propose an exception for say trading companies in respect of trading stock, while it was willing to exempt financial institutions in respect of financial assets.

(b) Location of asset factor

The fundamental question of the location of the asset factor is whether it should be located in the country where the owner is, where it is used, or determined by other criteria such as the location of the entity claiming tax depreciation on the asset.

Some EU experts suggested that the asset factor should be located in the country where tax depreciation on the asset is claimed under the CCCTB regime.\textsuperscript{156} This appears to have the initial support of the EC.\textsuperscript{157} However, for factor-shifting concerns, the current EC position is to "attribute the asset to the entity which is effectively using the assets".\textsuperscript{158} The rule is designed primarily to prevent shifting the asset factor by intra-group leases of assets.

The general location rule of effective use would be supplemented by a special location rule for leased assets between lessor and lessee belonging to different consolidated groups.\textsuperscript{159} In particular, in such cases, both lessor and lessee would recognise the leased asset in their respective asset factors, but at different valuations.\textsuperscript{160}

\textsuperscript{155} For example, the asset factor may be shifted to a low tax country by establishing a trading company there: ibid, paragraph 31.

\textsuperscript{156} WP52, paragraph 36.

\textsuperscript{157} WP59, paragraph 10.

\textsuperscript{158} WP60, paragraph 39.

\textsuperscript{159} Ibid, paragraph 40.

\textsuperscript{160} Valuation issue of leased assets would be discussed below. In essence, the economic owner of the asset would value the asset under the normal valuation rule (namely, tax written on
The following table summarises the EC proposal for the location of leased assets:

<table>
<thead>
<tr>
<th>Leased assets under</th>
<th>Location of asset at</th>
</tr>
</thead>
<tbody>
<tr>
<td>Intra-group lease</td>
<td>×</td>
</tr>
<tr>
<td>Third party lease – non-finance lease</td>
<td>(TWDV)</td>
</tr>
<tr>
<td>Third party lease – finance lease</td>
<td>(8 x rental)</td>
</tr>
</tbody>
</table>

Note: TWDV = tax written down value

It is apparent from the Table above that the leased asset issue is complex. The EC admitted that “these special rules could introduce some kind of complexities but are borne in the necessity of preventing manipulations ...” 161

The location of the asset factor is subject to other manipulation. For example, the factor may be shifted to another country by entering into sale-and-lease back arrangements. 162 It can be expected that the CCCTB regime would become more complex as more anti-avoidance provisions would inevitably be introduced.

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161 Ibid, paragraph 65.
162 WP52, paragraph 35.
(c) **Valuation of asset factor**

The asset factor may be valued by the following alternative methods, all of them very problematic:

(i) "User cost of capital"

In broad terms, valuation of the asset factor under this approach would equal to the "economic depreciation plus the financial cost of capital". The EC briefly discussed this alternative, which it believed to be the "theoretically correct approach". However, it was quickly dismissed as "the calculation would be complex and would involve a large number of subjective estimates".

The rejection of the "theoretically correct" valuation method is another example of compromises under the CCCTB regime for pragmatic reasons, thus making the regime less attractive than its proponents claimed.

(ii) Market value

It is widely accepted that *in principle* the asset factor should be valued at market value, which is a better measure of income-generating power of the asset than historical cost or tax written down value. However, market value is not used in practice, primarily due to practical difficulties and compliance costs to obtain market values of assets.

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163 WP52, paragraph 32.
164 Ibid.
165 For example, see McIntyre, above note 9, at 940; and WP52, paragraph 33.
For instance, “as a practical expedient”, most US states use original cost as the valuation.\textsuperscript{167}

Though recognised as the “ideal” approach, the EC also rejected market value as it “would create too many complications without providing significant benefits”.\textsuperscript{168}

(iii) Historical cost

Though it has little relevance to the income-generating power of an asset, historical cost is the option adopted by most US states on pragmatic grounds.\textsuperscript{169} However, it can create distortions and arbitrary results. For example, if a group has a subsidiary which acquired a winery 200 years ago at a small price and another subsidiary which has just acquired a winery for $100M, the group’s tax base would be allocated more to the second subsidiary even if the two wineries are equally profitable and productive.\textsuperscript{170}

(iv) Tax written down value

After rejecting the “theoretically correct” user cost of capital approach and the “ideal” market valuation approach, the EC proposed to use “CCCTB tax written down value” as the valuation of the asset factor.\textsuperscript{171}

\textsuperscript{167} Mcintyre, above note 9, at 940.

\textsuperscript{168} WP52, paragraph 33.

\textsuperscript{169} Wilkins & Gideon, above note 1, at 1264. Designers of the U.S. state FA regime admitted that historical cost was clearly arbitrary, but conceded that no valuation method would be “universally acceptable”: Coffill & Willson Jr, above note 1, at 1107.

\textsuperscript{170} This example is based on an example in Grierson, above note 166, at 1915. Historical cost was similarly criticised as “not only arbitrary, but also illogical”: Coffill & Willson Jr, ibid, at 1108.

\textsuperscript{171} WP52, paragraph 33. The EC did not consider historical cost appropriate as “comparability issues may arise due to depreciation at different rates or acquisition at different times”: WP47, paragraph 16.
The main argument for this option is that tax written down value "reflects most closely the market value of the asset".\textsuperscript{172} It is not clear if the two figures are "close" in practice. The answer is more likely to be negative, given the fact that virtually in all countries, the tax law provides balancing adjustments that reconcile the actual disposal proceeds of an asset and its tax written down value.

The tax written down value may be a convenient option, as the number is readily available in the CCCTB tax computation.\textsuperscript{173} However, it is problematic. First, tax written down value bears no significant relationship with an asset's income-generating power. Second, a fully depreciated asset would not be included in the asset factor but may still generate income for the group.

A related issue is whether to take the year-end tax written down value, or the average of the tax written down value for the year. This is basically a dilemma between simplicity and anti-avoidance concern. The year-end option is simple, but prone to manipulation.\textsuperscript{174} The avoidance opportunity is particularly attractive, as under consolidation intra-group transfer of asset is in general tax free. The EC is still seeking expert advice on this issue.\textsuperscript{175}

\textsuperscript{172} WP60, paragraph 36.
\textsuperscript{173} Another reason for the EC's choice is that as "all group members would be applying common (the CCCTB) rules the best comparability would be achieved ...": WP47, paragraph 16.
\textsuperscript{174} WP60, paragraph 38.
\textsuperscript{175} Ibid.
(v) Stipulated valuation formula
For leased assets between two entities belonging to different consolidated groups, the EC proposed a special valuation rule. Both entities would recognise the asset in their respective asset factor. The entity that claims depreciation on the asset would value the asset at tax written down value, while the other entity would value the asset at 8 times the net annual rental.\(^{176}\)

It is doubtful whether the EC’s proposed valuation formula of 8 times of rental is appropriate. The formula was suggested “in line with current practice in the U.S.. That would lead to a constant valuation in line with the historical cost approach, rather than tax written down value” (emphasis added).\(^{177}\) However, as discussed above, the EC rejected historical cost and proposed tax written down value as the general valuation rule for assets. The proposed “8 times of rental” valuation appears to be an inappropriate and inconsistent adoption of the U.S. model, and contradicts the general valuation rule.

In summary, the three factors raise serious problems and complexities when they are actually put into practice. The following comments by the EC nicely sum up the challenge (emphasis added):\(^{178}\)

The brief description of the three factors has shown that – in reality – there are no ‘ideal’ solutions and the choice concerning the definition, valuation and location of the factors and their inclusion ... in the formula requires a great deal of work.

\(^{176}\) Ibid, paragraph 40.
\(^{177}\) Ibid, footnote 13.
\(^{178}\) WP47, paragraph 20.
C.2.4.2.5 Weighting attached to each factor

This is a pure policy issue without any “principled basis to decide what weight should be given to a factor”.  

The EC observed that traditionally most of the states in the U.S. used to apply equal weightings to each of the three factors sales, payroll and property. However, since the early 1980s “the States have moved towards a greater weight given to sales … factor”. For instance, in 2004, 23 states used a formula giving the sales factor a 50 per cent weight, and 25 per cent to each of the payroll and asset factors.

Canadian experience shows a similar approach. The Canadian provinces have used for half a century an equally weighted formula with two factors: sales and payroll.

The EC rationalises such a weighting formula as a solution that “seems to be tailored at balancing the interests of the manufacturing and the marketing states” (emphasis added). The statement highlights that the weighting issue is a very political issue. More importantly, it reveals the fundamental problem of the weighting issue: competitions between jurisdictions. The real reason

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179 Brown, above note 11, at 764.
180 Ibid, paragraph 18.
181 Ibid. For a table summarising the weighting of factors in the states, see Bharat N Anand and Richard Sansing, “The Weighting Game: Formula Apportionment as an Instrument of Public Policy” (2000) 53(2) National Tax Journal 183, Table 1 at 190. It is interesting that four states allow taxpayers to choose whether or not to double weigh the sales factor. That flexibility contradicts with the fundamental principle that the FA method should allocate tax base according to a well-designed formula reflecting the income-generating power of various factors.
182 WP47, paragraph 18.
183 Ibid.
for the U.S. states to double-weigh (or more) their sales factor was “to encourage job growth within their states by reducing the adverse tax impact of locating facilities there” (emphasis added).\footnote{Coffill & Willson Jr, above note 1, at 1111.} It is not hard to imagine that independent jurisdictions – instead of states within one jurisdiction – would engage in similar or even more vigorous competition. Moreover, states taxes are typically not significant comparing with federal income tax. The stakes involved would be much higher in cross-border apportionment formula. Therefore, it is not difficult to foresee that it would be very difficult, if not impossible, for all countries to agree to a common weighting solution.\footnote{After finding that in the U.S. natural resource importing states tended to increase weighting on their sales factors, whereas natural resource exporting states on their production factors, Anand and Sansing argued that “a move towards a system of formula apportionment in which formulary weights are equalised across countries is likely to be fragile”: Anand & Sansing, above note 181, at 193-194.}

The EC has done exactly what is expected. After learning the overseas experience of the weighting issue, it shied away from the controversy and basically put it into the “political discussion” basket (emphasis added):\footnote{WP60, paragraph 13.}

\[
\text{... the weighting of the factors is not a technical issue and recommend that any discussion on the weighting be carried out at political level and once the impact assessment of the different possible options has been carried out.}
\]

The weighting given to each factor is critical to the share of tax base by each jurisdiction. The approach of the EC to defer the discussion is pragmatic and reasonable, but it highlights that a multilateral FA regime faces a formidable political obstacle. Even if member states manage to reach a compromise on the weighting issue, the resulting allocation formula would likely to be a
Appendix C Multilateral Consolidation – CCCTB Experience

product of political compromise instead of any fundamental principle of income-producing power.

C.2.5 Transitions between the two doctrines
Besides the issues discussed in Chapter 11 Section 11.5.3.5, the following paragraphs analyse other issues arising from the transitions between the two doctrines.

C.2.5.1 Joining issues
Split tax year
The issue is whether the income year of the joining subsidiary should be split into pre- and post-consolidation periods. Transition principle would suggest that it should. This is indeed the current position of the EC.\footnote{WP57, paragraph 97.} The position is supported by most member states,\footnote{WP48, paragraph 13.} though some suggested not to split the income year “in order to promote simplicity”.\footnote{WP59, paragraph 38.} It is unlikely that this position would be changed as it is “already applied in some MS and seems to be preferred by business”.\footnote{WP57, paragraph 97.}

C.2.5.2 Leaving issues
C.2.5.2.1 Unrealised gain in assets of a leaving subsidiary
A leaving subsidiary may take away from the group assets that have appreciated in value during period of consolidation. This raises the question of whether the group should have taxing right over the unrealised gain. The issue is particularly important and sensitive for a cross-border FA regime. The countries that would share the tax revenue on those gains under the

187 WP57, paragraph 97.
188 WP48, paragraph 13.
189 WP59, paragraph 38.
190 WP57, paragraph 97.
Appendix C Multilateral Consolidation – CCCTB Experience

Apportionment formula would be different from those that would be able to tax the gains under the separate entity doctrine after the leaving time.

Rollovers at both joining and leaving time is the current EC position, subject to an anti-avoidance measure (namely, if assets have been transferred from another group member to the leaving subsidiary within two years of leaving and the transfer is not for commercial reasons, deferred gains on the assets would be recaptured effectively at time of leaving). ¹⁹¹

C.2.5.2.2 Pre-consolidation losses

The exact nature of the issue of pre-consolidation losses with respect to a leaving subsidiary depends on how those losses are treated at joining time. The current EC position is to quarantine the losses at joining time. ¹⁹² In other words, pre-consolidation losses are not brought into the consolidated group, and can be utilised only by the subsidiary. This is a proper policy reflecting the transition from the separate entity doctrine to the enterprise doctrine.

The question is what should happen if the subsidiary leaves the group while it still carries some pre-consolidation losses. Under the quarantine approach, the answer is straightforward. ¹⁹³ Those losses have remained, and will remain, as losses of the subsidiary. In summary, the quarantine approach is applied consistently throughout the cycle of consolidation of the subsidiary, and properly reflects the transitions between the two doctrines.

¹⁹¹ The proposed measure would recapture such gains by taxing the disposal of shares in the leaving subsidiary: WP57, paragraph 109. It involves the complex dual cost base issue, which will be discussed in more detail below.

¹⁹² WP57, paragraph 100.

¹⁹³ The answer is so straightforward that the EC does not think it warrants mentioning in their discussion papers at all. For example, discussion on the treatment of losses upon leaving revolves around “losses generated during consolidation” only, and no mention is made on pre-consolidation losses: see for example, ibid, paragraphs 101-104.
C.2.5.2.3 Losses incurred during consolidation

During consolidation, the enterprise doctrine applies and the group is treated as one single entity. Overall losses of the group during consolidation belong to the group and not individual companies. It makes sense therefore to quarantine those losses to the group, when a subsidiary leaves the group.

This is the current position of the EC.\(^{194}\) It seems that the vast majority of EC experts agree to this policy.\(^{195}\)

The EC is also against recapture of cross-border loss compensation enjoyed by the subsidiary during consolidation, primarily to maintain the attractiveness of the CCCTB regime.\(^{196}\) This position is in accordance with the transition between the two doctrines.

C.2.5.2.4 Split tax year

Similar to the scenario of joining, most EC experts prefer splitting the tax year into two parts upon leaving.\(^{197}\) This is again a proper reflection of the transition between the two doctrines.

C.2.5.3 Group termination issues

C.2.5.3.1 Accumulated consolidated losses

Under the proposed CCCTB regime, a group’s election to consoli date is valid for a period of five years, and is automatically renewed for successive periods

\(^{194}\) Ibid, paragraph 103.

\(^{195}\) It was recorded that only “two experts were keen to calculate and allocate a share of accumulated losses to a company when it leaves the group” (emphasis added): WP53, paragraph 24. Some experts suggested that under this policy, “leaving company should ... be entitled to compensation as losses have an economic value”, but they conceded that “this could be dealt with by internal agreements within the group”: WP59, paragraph 42.

\(^{196}\) WP48, paragraph 14.

\(^{197}\) Ibid, paragraph 13; and WP57, paragraph 97.
of three years unless the group files a notice of termination.\textsuperscript{198} A consolidated group may also terminate when it is acquired by another company (which does not, or is not eligible to, elect to consolidate).\textsuperscript{199}

If a group has accumulated losses when it terminates consolidation, the issue is whether the losses should be shared out among group members, or stayed with the parent company. If former, it leads to the question of how the losses should be shared if the losses were accumulated over a number of years each with different allocation formulae.

When a group terminates consolidation, it represents a transition from the enterprise doctrine back to the separate entity doctrine.

The issue is controversial and the EC experts are divided on the alternative treatments of “stay with the parent company” and “share between group members”\textsuperscript{200} The EC position is to share out the losses, arguing that “this solution will lead to more fair results …”\textsuperscript{201}

This policy leads to the difficult question of how the losses should be shared among group members. The issues include whether it should be based on the apportionment formula at the time of termination or some kind of an average of formulae used in the years when those losses were incurred, and whether it should be shared among existing group members only or among both existing and previous group members.

\textsuperscript{198} WP57, paragraph 11.
\textsuperscript{199} WP53, paragraph 12.
\textsuperscript{200} Ibid, paragraph 25.
\textsuperscript{201} Ibid.
The EC position is a pragmatic one: the losses are to be shared out according to “the sharing [formula] at the date of termination”.\textsuperscript{202} It dismisses the suggestion to share out the losses using an average of past formulae as “it would increase complexity”.\textsuperscript{203}

C.2.5.3.2 Acquisition by another consolidated group

An interesting issue arises when a consolidated group “A” is acquired by another consolidated group “B”. The question is how the tax attributes of A should be treated. For example, should the accumulated losses of A be quarantined, or rolled over to B?

Similar to the analysis of pre-consolidation losses under normal joining circumstance, those losses should be quarantined. This represents proper application of the enterprise doctrine – namely, Group A is treated as one single entity under consolidation and thus its accumulated losses should be treated in the same way as pre-consolidation losses of a company – and would also avoid unnecessary complicated and arbitrary rules dealing with losses transferred to the consolidated group.

The EC does not seem to have a clear position on this issue yet. Some EC experts stressed the importance of the “quarantine” policy, while the EC indicated that “if it were to be the case ... symmetrical situation should have to be considered ... i.e. loss making group acquiring a profitable [group]” (emphasis added).\textsuperscript{204}

\textsuperscript{202} WP57, paragraph 104.
\textsuperscript{203} WP53, paragraph 25.
\textsuperscript{204} Ibid, paragraph 12.
The issues become more complex as the implications of the normal loss-trafficking rules have to be considered, and possibly modified for consolidated groups.

C.2.6 Interactions between the two doctrines
The introduction of a multilateral FA regime may increase complexity of a tax system due to the interactions between the applications of two doctrines at the same time, including:

1. interactions between a consolidated group and other entities; and
2. interactions between consolidated group members.

C.2.6.1 Interactions between a consolidated group and other entities
The enterprise doctrine applies within a consolidated group, while the separate entity doctrine applies to entities outside the group. A company in a consolidated group therefore has dual status: (i) not as a separate entity from the perspective of the group; and (ii) a separate entity from the perspective of entities outside the group. This raises the question of whether the company should be treated as a separate entity with respect to transactions with entities outside the group.

The introduction of a multilateral FA regime within a bloc (for example, the EU) increases the number of tax systems working within the bloc.205 The operation of one FA regime, and its interactions with the 27 national tax

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205 The CCCTB is most likely an optional regime, implying that all existing national tax systems will remain in operation: WP57, paragraph 85. Some Member States may even decide not to participate in the CCCTB regime all together, as they "may be afraid to give up too many powers and may be reluctant to confer executive powers on the Commission": Ben J Kiekebeld and Daniël S Smit, "The CCCTB: Wishful Thinking or Future Reality?" (2008) 50(4) Tax Notes International 321, at 322.
systems, would increase rather than decrease complexity of the tax system in
the bloc.206

The followings are some specific problems arising from interactions between
the two doctrines:

(1) Withholding tax
If a company within a bloc group under a multilateral FA regime pays
royalties to another company in a third country outside the bloc, the question
is what withholding rate should apply. A strict application of the enterprise
doctrine would suggest that the answer is not clear, as the payor is no longer
regarded as a separate entity within the bloc and thus arguably would have
lost its tax residence (say in Country A). In that case, it is not clear if the
withholding rate of Country A is still applicable to the royalties. However,
from the perspective of the payee, the royalties are paid from Country A and
therefore the withholding rate of that country (or under applicable tax treaty)
should be applied.

If it is agreed that the withholding rate of Country A is applicable, the
problem that follows is whether the withholding tax withheld by the company
in Country A should be shared by the group members under the FA method.
As the withholding tax is applied by applying the separate entity doctrine, one
may argue that the doctrine should be consistently applied to the withholding
tax collected. In that case, the tax would belong to Country A only, and not
shared among the group members. However, the other group members may

206 It has been argued that though the main argument for CCCTB is simplification, it is
difficult to see how the “proposed arrangement of 27 national systems plus the CCCTB could
achieve this”: Christiana HJI Panayi, “The Common Consolidated Corporate Tax Base -
Issues for Member States Opting Out and Third Countries” (2008) 48(3) European Taxation
114, at 115. Avoidance opportunities would also likely to be increased rather than reduced:
Wolfgang Schön, “Group Taxation and the CCCTB” (2007) 48(11) Tax Notes International
1063, at 1072.
argue that as the company is within the consolidated group, the enterprise doctrine should apply and therefore the withholding tax should be allocated among group members using the apportionment formula.

This kind of problems arising from the interactions of the two doctrines between countries is discussed in more detail in Section 2.7.2 “International issues” below.

(2) Transactions with related entities
Another issue is transactions between a consolidated group and its related entities. Some related companies of a parent company may not be included in its consolidated group, as the holdings are below the consolidation threshold (for example, 75% for the proposed CCCTB). In that case, transactions between the consolidated group and the related companies would still be recognised under the separate entity doctrine. In other words, significant transfer pricing issues are still prevalent under a multilateral FA regime.

(3) No-where sales
No-where sales issue is another example of the problems arising from interactions between the two doctrines. The issue is discussed in detail in Section C.1.8 above and in Chapter 11 Section 11.5.2(7). In summary, no-where sales issue arises if a portion of the tax base is allocated to a country, but the group does not have a “taxpayer” present in that country. If the enterprise doctrine is applied consistently and faithfully, it should not be an issue and that country should still have taxing rights over its share of the

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207 For discussion of issues of related parties in the proposed CCCTB regime, see for example European Commission, “Related parties in CCCTB” (CCCTB/WP/041, CCCTB WG, 2006) (“WP41”).
group's tax base. In other words, the taxpayer should be the group, instead of individual companies.

However, existing tax law and international tax norms are premised on the separate entity doctrine. For instance, the concepts of "resident" and "PE" are firmly and deeply imbedded in both national tax legislations and tax treaties. Countries in general find it difficult to accept the idea that a multinational group itself can be the taxpayer and a country can tax a group without a PE in the country. As a result, various arbitrary rules are created attempting to deal with the no-where sales issue. None of them is satisfactory.

C.2.6.2 Interactions between consolidated group members
The dual status issue of a consolidated group member also arises from the interactions between members of the same consolidated group. Examples of such problem include:

(1) "Stranded losses"
If a consolidated group incurs an overall loss, the issue is whether the loss should be allocated to group members immediately in the same way as for group's taxable income. Under the enterprise doctrine, a group should be treated as one single entity, and would have an overall consolidated group's taxable income or loss. Though the doctrine does not require that the group result be allocated to group companies, political reality dictates that group profit has to be allocated to group members every year, so that each participating country can collect their respective share of tax revenue. In other words, the enterprise doctrine concedes to the separate entity doctrine when a group's taxable income is allocated to each group member as separate entities. One may argue that group losses should be treated symmetrically.
This issue is controversial among the EC experts. The main concern is “stranded losses”. The issue can be illustrated with an example. Assume a consolidated group with a parent company and a subsidiary has consolidated loss of $100 in Year 1 and taxable income of $80 in Year 2, and the allocation ratios to the parent and subsidiary are 50/50 for Year 1 and 75/25 for Year 2 respectively. If the group loss is allocated to each member in Year 1, the tax outcome would be as depicted below:

Table 16 Problem of “stranded losses”

<table>
<thead>
<tr>
<th>Entity</th>
<th>Year 1</th>
<th>Year 2</th>
<th>Net</th>
</tr>
</thead>
<tbody>
<tr>
<td>Group</td>
<td>(100)</td>
<td>80</td>
<td>(20)</td>
</tr>
<tr>
<td>Allocation to:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Parent</td>
<td>(50)</td>
<td>60</td>
<td>10</td>
</tr>
<tr>
<td>Subsidiary</td>
<td>(50)</td>
<td>20</td>
<td>(30)</td>
</tr>
</tbody>
</table>

After offsetting carried forward losses from Year 1, the subsidiary would still be in a net loss position (known as “stranded loss”) while the parent company would have to pay tax on its share of taxable income of $10. This is not appropriate as the group has an overall net loss of $20. Under the enterprise doctrine, no consolidated group member should have to pay tax until the group as a whole has net taxable income.

208 It was reported at one stage of the consultation that experts “were equally divided on this issue”: WP46, paragraph 49.
The “stranded loss” issue would occur only in a multilateral FA regime. This is because under a unilateral FA regime, a country is under no pressure to allocate the group’s losses to its consolidated group members immediately.

The EC position is to keep the group losses at the group level, as it is consistent with the enterprise doctrine and avoids the stranded loss issue.\textsuperscript{209} The policy is pragmatic and reasonable, though inconsistent with the treatment of group’s taxable income.

\textbf{(2) Allocation to country or individual companies}

Under the enterprise doctrine, a group under the common control of a parent company is treated as one single entity. Following this logic, it is not necessary to allocate the group’s overall taxable income to each individual company in a country even if the group has more than one company in that country. Allocation to individual companies would represent an override of the enterprise doctrine by the separate entity doctrine.

However, practical consideration may suggest otherwise. The main concern is pre-consolidation losses of a company. As discussed in Section C.2.5.2.2 above, the current position of the EC is to quarantine such losses, meaning that only that company – instead of the group – can utilise the loss, and the offset is to be applied against the allocated portion of group’s overall taxable income – instead of the company’s own taxable income.\textsuperscript{210} This policy requires that the individual company must receive an allocation of the group’s

\textsuperscript{209} WP53, paragraph 23; and WP57, paragraphs 101 & 102.

\textsuperscript{210} WP57, paragraph 100.
taxable income; otherwise it can never utilise its pre-consolidation losses during consolidation.211

C.2.7 International issues
Cross-border transactions present a rich source of issues arising from the interactions between the two doctrines. Within a consolidated group, the enterprise doctrine prevails. However, outside the group, the separate entity doctrine is the norm. The tension between the two doctrines is particularly intense for cross-border transactions as the international tax regimes are typically premised on the separate entity doctrine.

Issues arising from international transactions include the followings:

(1) foreign tax credit ("FTC");
(2) withholding tax;
(3) participation exemption;
(4) conflict with tax treaties;
(5) concept of "resident";
(6) profits of a PE; and
(7) transfer pricing between a group and third parties.

The issues are discussed in more detail below.

C.2.7.1 FTC
Under the enterprise doctrine, if a member of a consolidated group derives foreign source income of $100 in a third country and pays foreign tax of $20 thereon, the income of $100 should be included in the group’s tax base while

211 If under the final CCCTB regime specific types of income is not included in the group’s tax base and instead stay with the company, it will be another practical reason for allocation to individual companies: WP47, paragraph 5.
the $20 should be treated as foreign tax paid by the group.\textsuperscript{212} As the $100 would be allocated to jurisdictions under the apportionment formula,\textsuperscript{213} the $20 foreign tax credit (FTC) theoretically should be treated in the same way.

The “FTC sharing out” policy is supported by the EC.\textsuperscript{214} One problem arises from such treatment of the FTC is the limit of the credit to be given by each jurisdiction. Under a typical FTC regime, the amount of credit available is capped at a maximum, equal to the domestic tax payable on the corresponding foreign income. This raises the issue of how the FTC limit rules should apply in the context of a cross-border consolidated group. For instance, if the $100 foreign income is allocated to two countries in the following manner:

\begin{table}[!h]
\centering
\begin{tabular}{|c|c|c|c|}
\hline
\textbf{Country} & \textbf{Foreign Income} & \textbf{FTC} & \textbf{FTC Limit} \\
\hline
A & 50 & 10 & 15 \\
B & 50 & 10 & 5 \\
\hline
\textbf{Total} & 100 & 20 & 20 \\
\hline
\end{tabular}
\caption{Issue of foreign tax credit limit}
\end{table}

The excess FTC of $5 in Country B would not be allowed as credit in the country. The question is whether the amount should be available as FTC in

\textsuperscript{212} In earlier discussions, some EU experts argued that foreign passive income should not be included in the consolidated tax base; instead it should be treated as income of the residence country exclusively: European Commission, “An overview of the main issues that emerged at the third meeting of the subgroup on international aspects” (CCCTB/WP/049, CCCTB WG, 2006) (“WP49”), paragraph 6. This policy violates the enterprise doctrine and is not supported of the EC, which prefers the scope of CCCTB to be “as wide as possible”: ibid, paragraph 7.

\textsuperscript{213} This is the position of the EC, even though it recognises that much of foreign income might be exempt: WP57, paragraph 118.

\textsuperscript{214} Ibid, paragraph 120. Such “FTC sharing out” policy was also suggested by McDaniel in his proposal of a FA system for NAFTA: McDaniel, above note 7, footnote 137.
Country A. The enterprise doctrine would say “yes”, as the whole group should be treated as one single entity and thus an overall FTC limit should apply for the group. However, political reality suggests that Country A may not be too enthusiastic to allow the additional FTC against its tax revenue.

It appears that the EC does not have a position on the issue yet. Instead, it simply stated that a “mechanism would be required for calculating the limit of the credit to be given by each MS”.\(^{215}\)

The FTC issue becomes more complicated if the foreign tax is a withholding tax on passive income. The question is what withholding rate should apply. If the income is allocated to 20 different jurisdictions under the apportionment formula, one may argue that, applying the current international tax rules, 20 different withholding rates should apply to the corresponding portions of the income. Life could be very complicated under this scenario.\(^{216}\)

**C.2.7.2 Withholding tax**\(^{217}\)

If a consolidated group pays dividend, interest or royalty to a third country, withholding tax in general would apply. There are two questions on the withholding tax:

1. what withholding rate should be applicable? and
2. should the withholding tax be shared out among jurisdictions?

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\(^{215}\) WP57, paragraph 120.


\(^{217}\) For a detailed discussion of the different scenario under which withholding tax may apply under CCCTB, see WP49, paragraphs 5-15.
In the absence of a common withholding rate applicable throughout the bloc, practical consideration dictates that withholding tax has to be levied at the withholding rate of the residence country of the payor company. This is consistent with the separate entity doctrine, under which the payor company is regarded as separate taxpayer. This is also consistent from the perspective of the payee in the third country.

A problem of this policy is that the consolidated group can effectively determine the withholding rate by choosing the location of the payor company. The shifting of payor is made more convenient as intra-group transactions are in general ignored under consolidation.

Another problem of withholding tax collected by a country within the bloc is whether that tax revenue should be shared out according to the apportionment formula. As discussed above, the withholding tax would be collected according to the withholding rate determined by the residence country. One may argue that a consistent application of the separate entity doctrine would imply that the withholding tax collected therefrom would belong solely to that country.

However, the EC believes otherwise.\textsuperscript{218} It argues for a symmetric treatment between deduction and withholding tax. As the payment of the passive income would be deducted against the group’s tax base, withholding tax collected on the payment should accordingly be shared among the countries using the same formula that allocates the tax base. The argument is consistent with that for foreign income and the corresponding FTC.

\textsuperscript{218} Ibid, paragraph 9.
A more intriguing situation is a cross-border payment of passive income within a consolidated group, which leads to the question of whether withholding tax should be levied. Under the enterprise doctrine, the whole group is treated as one single entity and intra-group transactions are in general ignored. Logically it follows that such payment should not be subject to withholding tax.

However, political reality again contradicts the doctrine. Some EU countries appear to insist on exercising the right to levy withholding tax on such intra-group payments. The EC’s position is that withholding tax levied on such payment should be shared out among jurisdictions “according to an agreed mechanism.”

The EC did not specify what the mechanism would be, possibly because this is a difficult and political sensitive issue. Given the insistence of some EC countries to protect their rights to levy withholding tax even on intra-group payments, it is doubtful if they are willing to share the tax with other countries. Even if they agree to share, the question is what should be the formula. On one hand, applying the general allocation formula (which is basically designed to deal with active business income) to passive income would violate the fundamental principle of the FA method and would produce arbitrary results. On the other hand, if a specific formula is designed for sharing out withholding tax, it would make the system more complex.

C.2.7.3 Participation exemption

The proposed CCCTB regime would require a common set of rules governing outbound investments. For instance, a common participation exemption

\[219\text{ Ibid, paragraph 11.}\]

\[220\text{ Ibid.}\]
regime has to be designed and agreed by all participating countries. The EC's suggested regime is exemption for major shareholding "subject to a switch over to the credit method where the corporate tax rate in the source country is low." The EC suggested that the threshold for switch over to credit method be a tax rate "of not less than 40 per cent of the average statutory corporate tax rate applicable in MS ..." That means the switchover rate would be 9.6 per cent, which is less than the current Irish rate.

The design of the participation regime is complicated by the need to protect the tax base from abuse. Besides the above-mentioned switch-over to credit method provision, other regimes being considered by the EC include a common controlled foreign company regime, and anti-avoidance regime to deal with "fat capitalisation".

In summary, the CCCTB regime would have to deal with complex international tax issues in very similar way as for the current international tax regime. It is difficult to argue that the CCCTB regime would be simpler than the current regime in this respect.

221 For discussion of the issue, see WP57, paragraphs 119-126.
222 Ibid, paragraph 120. "Major shareholding" means an interest of at least 10% of either capital or voting rights, which has been held for an uninterrupted period of at least 12 months: ibid, paragraph 125. The exemption would apply to both dividends and gains on disposals of the shareholdings: ibid, paragraph 126.
223 Ibid, paragraph 128. Some EC experts suggested that a fixed rate (for example, 10%) would be preferable in practice to the average method: WP64, paragraph 23.
225 WP57, paragraph 129.
226 Ibid, paragraph 130. "Fat capitalisation" refers to arrangements designed to take advantage of the participation exemption, by artificially converting taxable income into exempt (dividend) income, for example, by boosting equity in third-country subsidiaries.
C.2.7.4 Conflict with tax treaties

As the CCCTB regime represents a common set of rules applying to a large number of countries, it is inevitable that some of the rules may conflict with domestic tax law and existing double tax treaties. For example, the 10 percent participation exemption threshold suggested by the EC may conflict with existing tax treaties that provide for a lower threshold.

The EC's suggested approach is to "allow MS in certain aspects to derogate temporarily from the [CCCTB] rules adopted in order to respect existing obligations ...". This may be a pragmatic approach to deal with the conflicts. However, such flexibility would contradict the primary objective of the CCCTB regime, namely to provide a harmonised corporate tax environment in the common market.

Moreover, that approach would not be consistently applied. While the general position is that treaties would override the CCCTB rules, the EC insisted that "some anti abuse measures [for example, the switch-over mechanism to the credit method] would ... be necessary to protect the tax base [even though they] would ... in most cases conflict with the existing treaty network".

C.2.7.5 Concept of "resident"

The concept of residence represents a fundamental conflict between the separate entity and enterprise doctrines. The concept is firmly based on the
former doctrine, under which each company is treated as a separate entity, thus capable of having an individual residence. However, under the enterprise doctrine, the whole corporate group is treated as one single entity. The concept of residence for individual company does not sit well with the doctrine, which basically ignores the individual status of each group company.

The conflict implies that the policy makers have to draw a line to mark the transition between the two doctrines. For instance, as discussed in Section C.2.7.2 above in the context of withholding tax, if a third country company pays royalties to a consolidated group company, the issue is what should be the withholding rate. There are a number of possibilities, depending on where the line is drawn between the two doctrines:

1) The separate entity doctrine prevails:
   The first possibility is to respect the residence of the payee company and levy withholding tax accordingly. Though violating the enterprise doctrine, this is the most pragmatic approach, and consistent with existing treaty obligations.

2) The enterprise doctrine prevails:
   Under this possibility, the corporate group – as a single entity – would have to negotiate a single withholding rate with the third country. That withholding rate would be applicable to royalty payments to any member of the group. Though theoretically consistent with the enterprise doctrine, this approach is not practical as the group would have to negotiate with many countries in the world.
(3) Hybrid approach:
Under this alternative, the enterprise doctrine is applied first to allocate the royalty income to group members. The separate entity doctrine is then applied to determine the applicable withholding rate applicable to these shares of royalty income allocated to the countries. This approach would be very complicated to implement. It is also not feasible in practice, as the withholding has to be done at the time of payment of the royalties and cannot be delayed until the income allocation is finalised under the CCCTB regime, possibly many months later.

The EC position is basically in line with the above analysis: 232

... the CCCTB will not introduce a concept of a CCCTB area tax residence and companies will remind resident of a particular Member State, so that they are able to continue to receive benefits under the existing tax treaties.

**C.2.7.6 Taxable income of a PE**

PEs of a group in the EU are included under the CCCTB consolidation regime. This is so even if the head office of a PE in the EU is outside the CCCTB scope, that is, a "sandwich structure". The scenario is illustrated in Diagram 39 below:

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231 This possibility was suggested by Schön, above note 216, at 544-545.
232 WP46, paragraph 19.
233 WP57, paragraph 85.
234 Ibid, paragraph 87.
Diagram 39 Taxable income of PE in a sandwich structure

The problem is how the profits of the PE should be determined. Under the CCCTB regime, the PE will receive a share of the group’s overall taxable income according to the allocation formula. However, under existing treaties, taxable income of the PE have to be determined by treating the PE as a separate entity on an arm’s length basis. This raises a number of problems:

(1) The proposed CCCTB regime may be in conflict with existing treaties. If the CCCTB profit allocation to the PE is larger than the treaty allocation, the taxpayer may challenge the “excessive” allocation under the CCCTB regime.

235 Article 7 of OECD Model Treaty and its Commentaries.
(2) As the subsidiary is outside the scope of the CCCTB regime, it would allocate taxable income to the PE according to the separate entity doctrine. Such allocation would most likely be different from the taxable income allocated to the PE under the CCCTB allocation formula. In other words, there would be problems of double or no taxation.\textsuperscript{236}

\textbf{C.2.7.7 Transfer pricing between a group and third parties}

Under the proposed CCCTB regime, intra-group transactions would be eliminated upon consolidation and therefore “groups would be able to price the internal transactions \textit{as they wish}”\textsuperscript{(emphasis added)}.\textsuperscript{237} This raises the issue of what happens if one of the group companies is under transfer pricing audit by a third country. The audit would be more difficult and complex, as intra-group transactions within the CCCTB group can be priced arbitrarily by the group.

\textbf{C.3 Tax avoidance}

Besides the tax avoidance issues discussed in Chapter 11 Section 11.5.4, an additional issue relating to avoidance opportunities under the CCCTB regime is whether the regime should be optional or compulsory. EU experts were split on the issue, as “some in favour of the flexibility offered by ‘optional’, others preferring compulsion”.\textsuperscript{238} Some MS prefer a compulsory regime, as they worry about “cherry-picking” practices.\textsuperscript{239} This is understandable, as an optional regime provides flexibility for taxpayers to choose the most

\textsuperscript{236} Panayi, above note 206, at 118.
\textsuperscript{237} WP53, paragraph 33.
\textsuperscript{238} European Commission, “Summary record of the meeting of the common consolidated corporate tax base working group” (CCCTB/WP/025, CCCTB WG, 2006) (“WP25”), paragraph 29.
\textsuperscript{239} Kiekebeld & Smit, above note 205, at 322.
Appendix C Multilateral Consolidation -- CCCTB Experience

beneficial alternative. In other words, optionality inherently contradicts the policy objective of anti-avoidance.

The EC's position is to have an optional CCCTB regime. The main reason is "to allow [EU companies] to benefit from the single market" (emphasis added). This position echoes the strong desire of the business communities to have an optional regime.

C.4 Political resistance

National interest has always been the primary driving force behind international tax policies. In the absence of international agreements, both source and residence countries will likely exercise their entitlements in a way that serves their national interest. In his argument rejecting a "worldwide perspective" in international tax policy decisions, Graetz made the following observation:

240 Other reasons raised by EU experts against an optional regime included: (i) having two systems running side by side would be complex and difficult to manage for tax authorities; and (ii) it would be unfair to certain taxpayers, especially small and medium enterprises who may not have resources to deal with the complex CCCTB regime: European Commission, "Summary record of the meeting of the common consolidated corporate tax base working group" (CCCTB/WP/63, CCCTB WG, 2008) ("WP63"), paragraph 6. Of course, a compulsory regime would have its own problems, for example, all EU companies -- including SME -- would have to deal with a compulsory CCCTB regime, thus making the compliance costs very substantial.

241 WP57, paragraph 11. The optional regime would be protected by the "all in" rule, that is, all eligible group companies and PEs must join the regime if the group elects for CCCTB. The election would be valid for 5 years and unless elect otherwise would be renewed automatically for successive periods of 3 years: ibid.

242 WP53, paragraph 6.

243 WP64, paragraph 8; and Kiekebeld & Smit, above note 205, at 322.


245 Graetz, above note 2, at 277.
Appendix C Multilateral Consolidation – CCCTB Experience

We naturally give primacy to our own citizens in setting national policy, including tax policy ... No function is more at the core of government than is system of taxation ... Taxes are imposed by national governments (or their subdivisions); the power to tax is rarely delegated to multinational organizations.

This is the political reality that has been ignored or put aside, deliberately or otherwise, by many proponents of the FA regime. Even in an economic bloc such as the EU, it is important to understand that “an economic union is not the same as a political union and, for that matter, that a political union is not the same as an economic union”. Ignoring the political obstacles would render discussion of the FA method purely academic, if not utopian.

Besides the issues discussed in Chapter 11 Section 11.5.1, another issue with respect to the administration of the CCCTB regime is which country’s national court should handle appeals from administrative decisions. The EC proposes that appeals against administrative decisions should be made to the national courts of the principal taxpayer while final appeals would be to the ECJ. The proposal renders the choice of principal taxpayers more

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246 For example, the political obstacles were deliberately not addressed at all in an extensive and detailed discussion of the FA method, though they were admitted to be “formidable”: McIntyre, above note 9, at 918. Also, the legal framework of a proposed FA regime for North American Free Trade Zone was discussed in detail with the political constraint put aside by simply saying that “there are important political issues of sovereignty”: McDaniel, above note 7, at 702.

247 Richard M Bird, “A View from the North” (1994) 49(4) Tax Law Review 745, at 751. It is interesting to note, however, that the EC had reiterated that “the CCCTB would not interfere with MS sovereignty on tax matters ... The creation of a common tax base will not remove fair tax competition among MS, but would probably make tax competition more transparent” (emphasis added): WP46, paragraph 77. It is doubtful if the EC’s claim would be convincing to Member States.

248 The EC proposed that the answer should be the national court of the principal taxpayer: WP64, paragraph 33.

249 Ibid.
important. Some Member States are concerned that the system would encourage “principal tax authority shopping”, that is, “a potential concentration of [principal taxpayers] without economic substance in some countries which become automatically [principal tax authority] ... since [many] aspects of the administrative framework will not be harmonised (penalties, judicial appeals ...).”

The OECD provides a good summary of the political constraints that make a multilateral FA regime very difficult, if not impossible, to achieve (emphasis added):

Achieving a sufficient degree of international uniformity [on formula apportionment] would be very difficult and perhaps impossible ... in the absence of a universally agreed and economically rational conceptual basis for apportioning income and deciding which countries should have the right to tax, the international political consensus necessary to adopt formulary apportionment would be very difficult to achieve. Each country would likely be tempted to argue for the factors or weightings that give them the greatest share of tax revenues.

The CCCTB experience suggests that these political concerns are unlikely to be resolved in the foreseeable future, if ever at all.

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250 WP63, paragraph 9.

251 OECD, E-commerce: Transfer Pricing and Business Profits Taxation (2005, OECD, Paris), paragraph 319. Going back in history, the FA method was also considered and rejected by the League of Nations in 1927 and 1928, principally because of fears of upsetting the fragile compromise that permitted the League to issue the model income tax treaty of 1928: Graetz, above note 2, at 319.
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