INTERNATIONAL INCOME ALLOCATION UNDER EU TAX LAW: TINKER, TAILOR, SOLDIER, SAILOR

Rede,

in verkorte vorm uitgesproken bij de openbare aanvaarding van het ambt van bijzonder hoogleraar in Corporate Taxation and Corporate Finance aan Tilburg University op vrijdag 16 december 2016 door Daniël S. Smit
Esteemed Rector Magnificus,

Dear colleagues, students, family, and friends,

A famous Dutch cabaret performer once addressed the challenges of European integration in a pretty playful way. He referred to a Frenchman wanting to order another egg for breakfast somewhere in the United Kingdom. When the English waiter asks the Frenchman whether he wants to order something, the Frenchman replies, in French: “un oeuf”. The English waiter walks away, acknowledging that the Frenchman apparently had enough for breakfast. Consequently, the Frenchman gets nothing. At the same time, an Englishman is having breakfast somewhere in France. Being asked by the French waiter whether he wants to order anything else, the Englishman answers, in English: “enough”. A couple of minutes later, the Englishman is being served another hard-boiled egg.

Maybe this example sounds a bit frivolous and perhaps somewhat outdated, but in fact, it constitutes a metaphor for one of the most topical and emerging issues under European and international tax law. Let me explain this. What is happening in my example is that the same legal transaction (the breakfast order) creates different consequences in the two countries involved. Put differently, a “mismatch” occurs that is attributable to differences between the French and the English language. Now assume we don’t have two individuals, but two legal entities, two companies. One company is located in the United Kingdom (UK), the other one is based and operating in France. The UK company invests money in the French company by means of an inter-company loan. The French operating company has to pay interest on that loan, let’s say each day 1 fresh, French egg (“un oeuf”). Based on the French tax language (the French tax code), the payment of French eggs is recognized as a tax-deductible business expense in France. This means that the taxable business income of the operating French company is reduced. By contrast, based on the UK tax language (the UK tax code), the receipt of French eggs is not recognized as taxable business income. As a result, there is no corresponding taxation in the UK. The overall effect is that French taxable business profits are shifted to the UK where they remain untaxed at the level of the UK investor. Like in my previous example of our two hungry friends, there is an international mismatch. The reason for this mismatch is that the French and UK “tax languages” differ from each other, they are not aligned.

“Is that a problem?”, we must ask ourselves. And if so, which country should solve that problem, the UK, as the investor country, or France, being the country where the economic activities are carried out? And why?
In the wake of the recent financial and economic crises and the consequent growing pressure on government’s budgets, there is an increasing awareness in society that international tax mismatches indeed can be problematic. Especially large multinational enterprises, such as Google, Starbucks, Apple and Amazon, are perceived to deliberately seeking and even aggressively exploiting mismatches between national tax rules. As a result, multinationals have repeatedly been accused of not paying their fair share in repairing the costs of the financial and economic crises.

This recent and increasing public attention for business taxation of multinationals has created mounting pressure on government’s international tax policies. It is for that reason that in February 2013, the OECD, with the political support of the countries of the G20, has launched its ambitious project on Base Erosion and Profit Shifting.\footnote{OECD (2013), \textit{Action Plan on Base Erosion and Profit Shifting}, OECD Publishing.} Base erosion and profit shifting (in brief: BEPS) refers to, and I quote, “tax avoidance strategies that exploit gaps and mismatches in tax rules to artificially shift profits to low or no-tax locations.”\footnote{See \url{http://www.oecd.org/ctp/beps/}.} With the BEPS project, the OECD and G20 seek to create one single set of consensus-based, international tax rules to protect tax bases of countries. The BEPS project was finalized in October 2015 by releasing the so-called BEPS-package. This package contains 15 Actions that should provide governments the domestic and international instruments that are needed to tackle BEPS. Currently, the OECD focusses on supporting and monitoring the implementation of the BEPS package in both OECD and non-OECD countries.

Within the European Union (EU), the European Commission has strongly reaffirmed the OECD’s work on BEPS. In fact, the EU has taken the role of front-runner. Shortly after the release of the BEPS package in 2015, the European Commission has released a number of new legislative proposals. These proposals seek to implement, on a harmonized basis, parts of the BEPS-package throughout the EU. Already this year, the EU Member States adopted a number of these proposals and committed themselves to implementing them in their domestic laws shortly. On top of that, the Commission recently went one step further. This October it released two proposals for the phased introduction of a harmonized European corporate income tax regime, the so-called Common Corporate Tax Base (CCTB) and the Common Consolidated Corporate Tax Base (CCCTB). This regime would introduce one single “European tax language” spoken in all EU Member States. In the view of the Commission, this should do away with many international mismatches in a more comprehensive way. Finally, the EU Member States are currently contemplating to “export” at least some of the basic principles of the newly developed
“European tax language” to non-EU countries in order to ensure a minimum global level playing field. Non-EU countries that are not willing to accept these basic principles may be put on a so-called “black-list”. Once on that list, they could risk countermeasures at EU level.1

All these developments demonstrate that the existing international tax rules are currently being reassessed and reformed in a way that we haven’t seen before. Now, this current review and reform touches upon a much more fundamental question that actually goes beyond BEPS. It touches upon the question of international allocation of business income. If we have an investor located in country A that carries on business activities in country B, which country may tax which part of the business profits? Which country may have which “piece of the pie”, and why? On the basis of what underlying principle?

This question is certainly not new. But its relevancy has increased as a result of the current international developments that I have just described. The guiding principle that both the OECD and the European Commission follow here is that business profits should be taxed in the place where the economic activities generating these profits are performed and value is created. This principle refers to the more abstract notions of economic allegiance4 and source country entitlement.5 It refers to the idea that the country that has provided the public goods such as infrastructure and protection of property rights, which are all essential preconditions for an investor to run a profitable business, should be entitled to a “tax share” of the business profits generated in that country.6 It is this question of international income allocation, and the guiding principle that I will refer to from now on as “source country entitlement”, that I want to examine today from the perspective of the EU:

“How are the recent developments in European tax law influencing Member States’ international allocation rules for business income? And to what extent do these developments reflect the idea of source country entitlement?”

In addressing this question, I will focus on three main institutions of the EU: the European legislator, the Court of Justice of the EU and the European Commission. I will show that all three European institutions, it is true, do recognize the principle of source country entitlement. But... they do not do so full-heartedly. There is an English children’s counting rhyme, “Tinker, Tailor, Soldier, Sailor”. It’s a rhyme often used by children for “counting out”, for example to choose who shall be “it” in a game. But it can also be used to decide who will be the lucky one to get (tax!) something. (In the Netherlands, we would use the rhyme “Iene, Miene, Mutte”). With slight exaggeration, I see parallels between the Tinker, Tailor, Soldier, Sailor rhyme on the one hand, and the way recent developments in European tax law influence international income allocation rules on the other hand. In fact, the principle of source country entitlement is sometimes easily sacrificed in order to ensure that business profits are ultimately taxed once somewhere. But in which country, that doesn’t always really seem to matter.
In order to explain my proposition, let me start with the European legislator, because that’s where the primacy is when it comes to the creation of international income allocation rules. And in a way, the European legislator can be put on a par with the Tinker. Like the Tinker, it tries to fix something that is broken.\textsuperscript{7}

First and foremost, it is stressed that EU Member States already have to a great extent negotiated and divided income taxation rights with each other on the basis of bilateral tax treaties. For that reason, traditionally there has been very little European tax legislation on this point. But as a result of the recent BEPS-developments this has changed dramatically. The European legislator currently focuses on closing gaps in the current international tax system. And it tries to do so in two different ways.

Firstly, by requiring large multinationals doing business in the EU to increase their transparency. This means for example that multinationals need to report information about their global allocation of business income, economic activity and taxes paid among countries.\textsuperscript{8} This information is subsequently shared between the tax administrations of other Member States that have an interest. So by revealing the “bigger picture”, countries may discover more easily where a multinational is performing profit generating activities. Transparency therefore certainly facilitates countries to actually make use of their existing domestic taxation powers. But transparency by itself does not create new taxation rights. Therefore, transparency as such does not influence the international income allocation rules in Member States.

The second way in which the European legislator is trying to fix the international tax system is by introducing targeted anti avoidance rules throughout the EU. An important example of such a rule is the General anti-avoidance rule that has been included recently in the so-called Parent-subsidiary Directive.\textsuperscript{9} This rule mainly focuses on the phenomenon of so-called “letterbox” companies located in the EU. “Letterbox” companies can be used to “channel” profits of European operating companies to non-EU shareholders without triggering dividend taxation in the EU country where these profits were generated. The new rule seeks to establish that operating companies paying out their profits to a

\textsuperscript{7} Or at least something that is perceived to be broke; some people may disagree and say: “if something ain’t broke, don’t try to fix it!”


\textsuperscript{9} Article 1(2) of Council Directive 2011/96/EU of 30 November 2011 on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States (consolidated version as it reads on February 17, 2015).
“letterbox” company located in the EU that was put in place for the main purpose, or one of the main purposes, of obtaining a tax benefit, must withhold tax on such profit distribution. So we clearly see the creation of a new European income allocation rule here. Indeed, this allocation rule can be linked to the idea of source country entitlement: the country where the distributed profits were generated may, and in this case even must tax these profits. So far, so good.

Let me introduce some variations on this theme. Assume now that the operating company doesn’t pay a dividend, but makes an interest payment to the “letterbox” company. Does EU tax law require the operating country to tax that interest payment as well? The answer is: no. It is true that the European Commission seeks to introduce a new set of rules that would create such an obligation for cases like this, or that would even require a minimum level of taxation at the level of the “letterbox” company. Up to now, however, these solutions didn’t appear feasible for all Member States from a political point of view. In fact, the current European rules even require the operating country to fully exempt the interest payment from taxation. Although one may argue that this obligation does not apply to payments to “letterbox” companies10, it can at least be established that in this interest example, the idea of source country entitlement is less dominant; there is no obligation to tax.

Let us mix the two examples a little and go back to my previous “egg-example”. As a quick refresher, in that example, the payment of interest was qualified as a tax deductible business expense in France, the operating country, whereas it was seen as a tax-exempt dividend in the UK, the state of the investor. The recently introduced “linking rule” in the Parent-subsidiary Directive says that in such a case, the UK should tax the payment.11 Hence, the country of the investor must tax. However, this is not necessarily the state where profit generating economic activities are performed.

Now assume that the UK company would receive a similar payment from an operating company located outside the EU, let’s say Switzerland. Recently, it has been proposed to apply the same solution in the relations with non-EU countries.12 So again, the UK as the investor country should tax the payment in this situation. Only if Switzerland as the operating country would decide to deny the deduction of the payment, then the UK is no longer obliged to tax. Although this latter solution is indeed more in line with the idea of source country entitlement, the overarching principle of the new rules seems to be that the business income should eventually be taxed somewhere once, if not in the operating country (France or Switzerland), then at least in the investor state (the UK).

Let us now assume that the UK company is not providing a loan directly to the French company, but indirectly through a subsidiary company or a branch located in a non-EU country, let’s say Switzerland again. If the income received by the Swiss subsidiary or branch is not sufficiently taxed in Switzerland, that income may be deemed to be income of the UK company.13 In such a case, the income on the loan must still be taxed in the UK, the investor country. By contrast, if the level of taxation in Switzerland is sufficient, then no pick-up of the income in the UK is required. So here, it is primarily the foreign effective tax rate, rather than the foreign presence of profit generating economic activities, that decides whether or not the UK should tax the income. In addition, it may well be that in this case, the applicable tax treaty actually disallows the UK to fully tax the Swiss branch or subsidiary income, precisely because of a sufficient economic link with Switzerland. But the new rules do not give priority to the tax treaty rule in such a case. In fact, and rather remarkably, they are completely silent on this matter!

Finally, we now focus on the French operating company. Assume that the French company is now making the same payment to a company located outside the EU, let’s say Norway. In such case, it is proposed that France must deny the tax-deduction and increase the French company’s business income.14 But this source state friendly obligation will immediately be waived if Norway, as the investor state, decides to tax the received income. Again, the real leading principle here seems to be that business income should eventually be taxed once somewhere.

I think I made clear that recent EU tax law developments are indeed influencing international income allocation rules of Member States. However, these rules do not really adhere to the idea of source country entitlement. It seems they leave the question in which country business profits may or must be taxed the mere outcome of a “Tinker, Tailor, Soldier, Sailor” rhyme.

11 Article 4(1)(a) of Council Directive 2011/96/EU of 30 November 2011 on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States (consolidated version as it reads on February 17, 2015).
13 Based on the CFC-rules under Article 7 and Article 8 of the Council Directive (EU) 2016/1164 of 12 July 2016 laying down rules against tax avoidance practices that directly affect the functioning of the internal market.
Now we move on to the Tailor. Who would be the Tailor? It is the Court of Justice of the EU, because like the Tailor, the Court creates custom-made solutions for a specific individual case. The Court must assess, in individual cases, whether a Member State is discriminating against cross-border business activities without a valid justification. If this is the case, the Member State in question must withdraw the discriminating tax measure and replace it by the tax measure which that Member State applies to comparable domestic business activities. By doing so, the Court seeks to ensure equal tax treatment between domestic and cross-border business activities in order to guarantee fair competition.

When it comes to income allocation rules, the Court has constantly held that Member States “are free to determine the criteria for taxation on income with a view to eliminating double taxation”.15 In other words, the international allocation of business income, “dividing the pie”, is a matter for the Member States, and not for the Court, to decide. The Court therefore has never made a fundamental choice between investor-country-based taxation and operating-country-based taxation. The Court accepts both systems, as long as they are applied in a consistent, non-discriminatory fashion.16 This fully makes sense. Because otherwise, the Court would have to decide which country may have which “piece of the pie”. By doing so, the Court would start acting as a legislator. But rulemaking is not the task of the Court. It should only interpret, but not create European income allocation rules. A Tailor is not a Tinker. So, it seems that we can already close the Tailor chapter here; when it comes to international income allocation rules, there is no role for the Court.

Unfortunately, life is not that simple. This is because the Court appears to deviate from its own doctrine from time to time. A notorious example is the Marks & Spencer case.17 By the end of the 90’s, Marks & Spencer, the famous UK retailer, did not do so well overseas. In fact, with its local subsidiary companies, it suffered business losses in France, Belgium and Germany. In 2001 Marks & Spencer decided to terminate its overseas activities. The French subsidiary was sold, whereas the activities of the Belgium and German companies were terminated. On balance, in all three European countries, Marks & Spencer suffered a definite business loss. Now, Marks & Spencer wanted to deduct these overseas losses from its UK business profits. However, the UK tax administration refused. The reason was that the losses were suffered by overseas companies, and not by UK companies. Following the principle of territoriality, the

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17 ECJ 13 December 2005, C-446/03, Marks & Spencer.
applicable tax treaties did not allow the UK to take any positive or negative business income of the overseas companies into account. Despite the fact that the Court recognized that the losses had not originated in the UK, the Court still decided that the UK should allow for a deduction of these losses, assuming that these losses could be considered as “final” losses. A final loss means a definite loss suffered upon the termination of the overseas business activities that can no longer be deducted in the overseas countries. With the Marks & Spencer decision, the Court has created, in substance, a new international allocation rule for final business losses, because apparently, these losses have to be taken into account in the UK as the head-offices country. By ruling so, the Court not only overruled the existing tax treaty allocation rules. It also waived the principle of territoriality or source country entitlement.

Let me introduce again a variation on a theme. As I just explained, the Court required the UK, as the head-quarters country, to make its own tax rules on loss relief dependent on loss relief possibilities available in the overseas operating countries. The interesting question arises whether the operating countries could do the same. Could an operating country make the deduction of operational losses conditional on the requirement that these losses cannot be deducted in the head-quarters country? The Court answered this question in the Philips Electronics case with a “no”. In this case, Philips Electronics wanted to offset losses of a UK branch against its own UK profits. But the UK tax administration refused. The reason was that the branch loss was already tax-deductible in the Netherlands, at the level of the Dutch head-office. The Court decided, however, that the UK should allow the loss deduction. The reason was that both the branch losses, and Philips Electronics’ profits found their origin in the UK. So contrary to the Marks & Spencer decision, the territoriality principle did prevail in this case. Despite the fact that the loss could also be deducted in the head-offices country, the Court did not waive this principle.

I agree with this decision. Because if the Court had accepted the UK’s reasoning, one could easily get caught in a circular reasoning. The head-offices country could make the loss deduction dependent on the non-deductibility in the operating country. The operating country could make the deduction of the same loss dependent on the non-deductibility in the head-offices country. Taking both decisions together, I think it’s safe to conclude that the Court considers the deduction of operating losses primarily a matter for the operating country. So source country entitlement, the negative side of it, prevails.

Only in the exceptional case of definite operational losses, deduction may become a matter for the head-quarters country. So to sum up, the influence of the Court’s case law on international income allocation rules of Member States appears to be limited.

But before we say goodbye to the Tailor, I want to address one final development in the recent Court’s case law, because this development potentially changes my conclusion dramatically. It relates to the concept of fiscal discrimination. As I said earlier, the Court must assess, in individual cases, whether a Member State is discriminating against cross-border business activities without a valid justification. If this is the case, the Member State in question must withdraw the discriminating tax measure and replace it by the tax measure which that Member State applies to comparable domestic business activities. So this tax measure for domestic business activities constitutes the benchmark rule. This domestic benchmark rule forms the starting point when assessing whether a Member State is discriminating against cross-border business activities.

Now having a critical look at some of the recent Court decisions, it seems that the Court has started stretching the fiscal discrimination concept by introducing its own benchmark rules. An example is the recent decision in the case of the Belgium pension fund Metaal en Techniek. In this case, Sweden subjected Swedish dividend payments received by Swedish pension funds to one particular tax regime (taxation based on a fictitious income basis). By contrast, it subjected Swedish dividend payments received by foreign pension funds to another tax regime (gross taxation on a real income basis). The Court decided that this was not discriminatory. Seen from the angle of the objective of the tax regime for Swedish pension funds, Swedish and foreign (Belgian) pension funds are not comparable. Still, the Court suggested that one specific element of the tax regime for Swedish pension funds may have to be extended to foreign pension funds as well. This element relates to the deduction of professional expenses that are directly connected to the receipt of Swedish dividends. Despite the fact that Swedish and foreign pension funds may be subjected to two, different tax regimes, the Court decided that Sweden should grant foreign pension funds a deduction of these expenses if such deduction is also granted to Swedish pension funds. By doing so however, the Court has started blending elements of the two different regimes. And it is the blend that is subsequently used as the new benchmark. A benchmark that says that Sweden must allow a deduction of certain expenses connected to Swedish portfolio investments made by foreign pension funds, and which thus creates a new international income allocation rule.

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18 ECJ 6 September 2012, C-18/11, HMRC v Philips Electronics UK Ltd.

19 CJEU 2 June 2016, C-252/14, Pensioenfonds Metaal en Techniek v Skatteverket.
Something similar was happening in the Groupe Steria decision. Now I am not going to discuss this decision in more detail, and its potential influence on the Dutch group consolidation rules. But also that decision implies that the Court is blending features of two different tax regimes – consolidated and stand-alone taxation – and subsequently takes the blend as a new benchmark that has no equivalent in the domestic tax rules of the Member States. If my interpretation of the recent Courts’ case law is correct, that would blur the concept of fiscal discrimination dramatically. And potentially it would open the door for the Court to create new international income allocation rules. But again, this is not the task of the Court. For the sake of legal certainty and equality, the Court should stick to its role of the Tailor. It should interpret rules of EU tax law, but not create them. This brings me, finally, to the Soldier.

20 CJEU 2 September 2015, C-386/14, Groupe Steria SCA v Ministère des Finances et des Comptes publics.
Now since there is only one European institution left, it is easy to guess who the Soldier is. It is the European Commission. Why? Because like the Soldier, the European Commission currently is on the warpath. The European Commission must monitor whether Member States and European enterprises comply with the European competition rules. One element of the European competition rules is the prohibition on fiscal state aid. It is on the basis of this rule that the European Commission, led by Margrethe Vestager, is currently attacking certain international tax planning structures that are used by individual multinationals. The European state aid rules say that Member States are, in principle, not allowed to grant preferential tax treatment to one group of enterprises while denying such treatment to other enterprises that find themselves, in the light of the objective pursued by the measure in question, legally and factually in a comparable situation. A preferential deviation from the normally applicable business tax rules, selective favorable tax treatment, may boil down to illegal state aid. If the Commission determines that a Member State is granting illegal state aid, it will normally require that Member State to recollect the tax benefit from the beneficiary as it was granted over the past 10 year-period, including interest. The situation must therefore be restored as if no state intervention had taken place. The state aid prohibition straightly reflects the core of the European liberal market. Enterprises must be able to compete with each other on equal terms and should be able to survive competition on the European market on their own, so without state intervention.

Now as said, the Commission is currently trying to combat international tax planning structures on the basis of the European state aid rules in specific, individual cases. Large and well-known companies, such as Apple, Amazon, Fiat Chrysler, Starbucks and McDonald’s are currently under fire. And more companies are expected to follow. Before I will briefly discuss two of these cases, McDonald’s and Apple, it is useful to firstly have a look at the Court’s decision in the Gibraltar case that was released in 2011. Gibraltar wanted to introduce a new business income tax regime for companies. However, the proposed main criteria for tax liability did not consist of business income, but of premises and employees. The more premises and employees, the higher the company tax bill. No or almost no premises and employees, no or almost no company tax to be paid. The Commission had found this to be incompatible with the state aid rules. Gibraltar wanted to introduce a new business income tax regime for companies. However, the proposed main criteria for tax liability did not consist of business income, but of premises and employees. The more premises and employees, the higher the company tax bill. No or almost no premises and employees, no or almost no company tax to be paid. The Commission had found this to be incompatible with the state aid rules. On appeal the European Court agreed with the Commission. The Court decided that one specific group of companies, namely offshore companies (or “letterbox” companies),

22 For example ECJ 8 November 2001, C-141/99, Adria-Wien Pipeline, para. 41.
would specifically benefit from the contemplated business tax regime. This is because “letterbox” companies typically have no or almost no premises and employees in place. Therefore they would pay no or almost no company tax in Gibraltar. So the proposed rules would in fact favour “letterbox” companies against other companies.

Merely based on the gut feeling, this decision seems logical. But the Court’s decision raises one important, conceptual difficulty. Because let us assume that the Gibraltar business tax rules were already being applied in practice. How then should one calculate the tax benefit to be recovered from the “letterbox” companies? Because remember: state aid is about the selective deviation from the normally applicable tax rules, a deviation from the benchmark rule. Normally, one would first calculate the taxes due under the benchmark rule, and then compare the outcome to the taxes due under the preferential tax rule. The difference then needs to be recovered from the beneficiaries. But in the Gibraltar case, the proposed criteria for tax liability were part of the benchmark rule. And so the benefit for “letterbox” companies actually followed from the application of the benchmark rule. The Court’s decision therefore implies that the benchmark rule was wrong. And that implies that there must be another, European benchmark rule. A rule that says what a business tax regime for companies should at least look like. Now with this decision in mind, let’s go back to two of the current state aid attacks, because despite the peculiarities of the Gibraltar case, the Commission here seems to generalize the Court’s approach.

Firstly, the McDonald’s case. In the period between 2009 and 2013, McDonalds was channeling significant amounts of royalty income through a Luxembourg company. From a Luxembourg tax point of view, this income was totally attributable to the US. The Luxembourg tax administration therefore confirmed that this income was fully exempt from Luxembourg company taxation on the basis of the tax treaty with the US. However, the US did not recognize the royalty income as being generated in the US. Therefore, no corresponding taxation in the US took place. Is Luxembourg granting preferential tax treatment to McDonald’s in this situation? Is this state aid? The Commission’s preliminary conclusion is: yes.25 Based on a faithful tax treaty interpretation, the Luxembourg tax authorities should not grant the exemption, the Commission says. This is because it is clear that the royalty income cannot be taxed in the US based on US domestic law whereas the tax treaty requires Luxembourg to only exempt income that may be taxed in the US.

In my view, this reasoning is debatable. Tax treaties typically only allocate income taxation rights between countries. But they do not require countries to actually make use of their taxation rights. But what the Commission essentially seems to try to achieve, is that Luxembourg will no longer exempt foreign branch income if that income is not subject to tax in the other country. By doing so, the Commission would create, with retroactive effect, a new international allocation rule. However, such rule-making would go beyond the competence of the Commission. The Commission is not a Tinker. We must now eagerly wait and see whether the Commission will uphold its reasoning in its final decision in this case.

A second example is the notorious Apple case. The European Commission has recently decided that the Irish tax administration wrongfully accepted a too low tax charge on Apple’s sales profit in Ireland. The profits that had to be allocated to Ireland should have been much higher. The Commission decided that this boils down to illegal preferential treatment by Ireland to Apple. Ireland now has to recover from Apple an amount of 13 billion euro, plus interest.26 But why is this illegal state aid? It is true that the effective tax rate in Ireland for Apple is low. But as long as this low rate applies to all Irish enterprises in similar circumstances, there cannot be preferential, selective tax treatment. Based on what has been published so far in this case, the Commission doesn’t make clear how Ireland is deviating from the Irish benchmark rule. Rather, it seems that the Commission is applying a new, autonomous benchmark rule in this case. A European standard that says that profits to be allocated to Ireland should be in line with arrangements that take place under commercial conditions between independent businesses. Hence, a European arm’s length standard. It seems that precisely on the basis of this new standard that the Commission considers the Irish profit attribution to Apple’s sales activities too low. Again, by doing so, the Commission is introducing, with retroactive effect, a new international income allocation rule.

Not entirely as a surprise, both Apple and Ireland have decided to appeal before the European Court. But for the time being, Apple should pay back as much as 13 billion euro, plus interest, to the Irish government. Here is where the counting rhyme comes into play again. Because the Commission has indicated that this recovery amount may be reduced again. It may be reduced if other countries, for example the United States (US), would now find that some part of the Irish profits actually belongs to them and consequently would decide to tax those profits. By doing so, the Commission seems to


simply sacrifice already its European standard for the allocation of international business profits. On balance, it doesn’t really seem to matter where Apple’s sales profit will be taxed, as long as these profits are ultimately taxed somewhere once. Ireland is primarily responsible to ensure taxation, but if the taxation eventually takes place in another country, then that’s fine as well.

In my view, this reveals the real problem that is behind the Apple case. Because looking at the bigger picture, there is an international mismatch. Part of Apple’s profits are eventually taxed nowhere, not in Ireland based on the Irish tax code, but also not in the United States, based on the US tax rules. It is true that such a mismatch may distort competition in the European market. But the overall effect of non-taxation flows from a disparity between the Irish and US tax rules. From a state aid point of view, this effect is not attributable to one single country alone. The benefit simply follows from the fact that the normally applicable tax rules of both countries are not aligned. I don’t think it falls within the Commission’s competence to attack such a disparity. But it seems that the Soldier is marching to a different drum here. Finally, the US is “not amused” by seeing that the Commission is forcing Ireland to tax income that eventually should be taxed in the US, once the profits will be repatriated to Apple US. Indeed one may wonder whether the real added value for Apple’s products isn’t indeed predominantly created in the US and not in Ireland. Be that as it may, the conclusion is that the state aid rules are influencing Member States’ international income allocation rules too. But again, the question as in which country business profits must be taxed seems to be the mere outcome of a “Tinker, Tailor, Soldier, Sailor” rhyme.
Now we discussed the Tinker, the Tailor and the Soldier, but there is still one person left: the Sailor. Who would be the Sailor? The Sailor stands for Academia. Typically, the Sailor navigates to his place of final destination. He determines where eventually we should end. And as academics we should ask ourselves: “What should international allocation rules for business income eventually look like within the EU? What should be the final destination?”

I consider the outcome of the Tinker, Tailor, Soldier, Sailor rhyme a shaky basis for the creation of new international income allocation rules. Endorsing this rhyme as a basis is certainly not without pitfalls. Firstly, it increases uncertainty. It is no longer always clear in advance in which country a multinational should pay its annual taxes. Secondly, it affects the sovereignty of Member States. This is because the operation of the domestic tax rules of one Member State becomes dependent on the operation of the domestic tax rules of other states. In fact, a change in the domestic tax rules of a foreign country could “soak-up” (“steal”) the tax bases of the Member States. This could lead to undesirable tax competition between countries as well. Finally, in the worst case, countries could simply disagree with the children’s rhyme outcome, and start claiming the same “piece of the pie”. Double taxation (“overkill”) could then be the result.

In my view, the recent developments in EU tax law focus too much on treating the symptoms, instead of the causes of profit shifting and base erosion. If the European legislator wants to take the idea of source country entitlement seriously, a different approach is required. I want to refer to a commentary written by Van Brunschot in the late 80’s. There, he states the following:

“How from an economic perspective, put with slight exaggeration, the establishment of subsidiaries in other countries lack any real significance. The legal structure does, by itself, not add anything to the economic happenings within an enterprise. (...) In my view, the right approach is to determine, as precise as possible, the income and profits that from an economic point of view are sufficiently linked with the Netherlands territory. To that end, one only needs to determine in which place the activities take place and which value one should attribute to them, based on the arm’s length standard.”

In my view, this is indeed the direction in which European business income allocation rules should develop in the future. Less emphasis on legal reality, less focus on treating
International income allocation under EU tax law: tinker, tailor, soldier, sailor

symptoms, but more focus on economic reality in which multinationals operate, more emphasis on the causes of BEPS. There is no need to reinvent the wheel in this respect. Firstly, we can already derive from the Court’s case law that the freedom of enterprises to establish a branch or subsidiary company in another Member State, implies a genuine economic link with the territory of that Member State through the exercise of a genuine economic activity. Therefore, the European freedom of establishment essentially is an economic concept.28 This concept could perfectly serve as a basis for future rulemaking. Secondly, an economic approach for international business income allocation can already be found in the OECD’s 2010 Report on the Attribution of Profit to Permanent Establishments.29 By its nature, this report provides detailed guidance for allocating profits to branches, as opposed to legal entities. For example, it provides economic approaches to allocate third-party interest expenses to the various branches of one single enterprise.30 It provides guidance as to how income from intangible property should economically be allocated to the various parts of one single enterprise.31 It gives rules to determine how the provision of internal services between parts of one single enterprise must be remunerated.32 Etcetera.

Essentially, a multinational that runs business through various legal subsidiary companies can from an economic point of view also be seen as one single, internationally operating enterprise, as one economic unit. In my view therefore, international business income allocation rules for multinational companies should approach multinationals accordingly. This would enhance the source country entitlement principle and, consequently, international tax neutrality. On top of that, it could create a proxy for tax competition by requiring substantial activity for preferential tax regimes. Finally, it would enhance symmetry, provided that a proper international dispute settlement framework, including taxpayer protection and the possibility to obtain certainty in advance, is introduced for cases where the countries involved do not apply the rules in the same way. Situations of non-taxation and double taxation should then be reduced. Of course, the existing guidelines would need to be developed further; they are only a starting point. Furthermore, it will not always be an easy task to determine where exactly income is generated, where the significant people functions are performed.33 So implementation would certainly require a careful step-by-step approach. Nevertheless, my call is that if the European legislator wants to take the idea of source country entitlement seriously, it should not stop where it is right now. The Tinker should join the Sailor and move on together. The current implementation of the BEPS-package within the EU should be considered as a temporal step only, an emergency brake perhaps. However, it should not be considered as a final system. In the context of the special chair on Corporate Taxation and Corporate Finance, I hope to make a contribution, as an Academic, to the development of a final system in a fruitful and inter-disciplinary way.

28 D.S. Smit, op cit., pp. 33 et seq.
29 OECD (2010), Report on the attribution of profits to permanent establishments.
30 paras. 154 et seq.
31 paras. 83 et seq.
32 paras. 216 et seq.
Let me conclude with some words of gratitude. I thank the Board of Tilburg University for appointing me, and the Dean for nominating. I am eager to contribute, with the Fiscal Institute Tilburg, the Department of Finance and in my own academic work, to the health and reputation of Tilburg University as a whole.

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Ik heb gezegd.