Principles and standards of transnational taxation
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From national towards global tax systems

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“We can’t solve problems by using the same kind of thinking we used to create them.”

- Albert Einstein
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Bart W.J. Konings
1. Introduction

1.1 Motivation of the research

‘Taxation is a subject not usually associated with the lighter or more cheerful thoughts of men’.¹ This is also the case with the current 2008 financial and economical crisis, which is considered to be the worst economic crisis since the Great Depression of 1929.² Although taxation has not generated the crisis, it might have contributed to it.³ Activities like tax avoidance, tax evasion, and tax planning cost the society lots of money. However this is not something from the last decades: the phenomenon of tax evasion is well-known since ages. Hemels e.g. mentioned bricked windows as silent witnesses of tax evasion.⁴ In the Nineteenth Century taxes were levied on external signs of wealth such as doors and windows. As a result, people bricked their windows closed to prevent them from being included in the taxable amount of their income.

Nowadays the techniques are considered to be a lot different from the bricked windows. Therefore subjects as tax transparency and the fight of cross-border tax evasion have been key topics at G20 Summits in Washington, London, Pittsburgh, Toronto, Seoul and Cannes. In the view of Rosembuj recent developments from The G20 give rise to optimism. In his view the work of the G20 resulted in the development of two new principles: i.e. the principle of anti-erosion of the tax base and the principle of harmful tax competition.⁵ The erosion of the tax base is a result of tax evasion, whereby an example of the climax of this development could be described as the so called ‘stateless income’ situation.⁶ This would be the situation when there are states that do have taxes but do not have significant taxpayers. Stateless income is then, in this case, the result of the possibility of non-taxation all over the world, through activities like tax avoidance and tax evasion. In this respect the term tax evasion generally compromises illegal arrangements where liability to tax is hidden or ignored (i.e. the taxpayer pay less tax than he is legally obliged to pay by hiding income or information for the tax authorities).⁷

³ Ibid.
⁷ EC, On concrete ways to reinforce the fight against tax fraud and tax evasion including in relation to third countries (COM 2012, 351), Brussels, 27 June 2012. p.1. Tax fraud is herein a form of deliberate evasion of tax which is generally punishable under criminal law. The term ‘tax fraud’ includes situations in which deliberately false statements are submitted of fake documents are produced.
Contrary to tax evasion (and tax fraud), both tax avoidance and tax planning do not constitute a criminal offence. International tax avoidance can reflect both legal and illegal actions, it is sometimes used in the sense of ‘legal reduction in taxes’ while tax evasion refers to illegal activities.\(^8\) However the dividing line is not entirely clear.\(^9\) With respect to the current discussion on ‘tax practices and crisis’, harmful tax competition could not be missing. This could be described as the ‘battle’ between countries that are willing to attract investors via an tax friendly environment, \textit{i.e.} countries that are no longer willing to tax capital income at all cost, and countries that exert their tax jurisdiction as far as possible.\(^10\) The truth is that as long different tax systems exist, without being based on the same principles, tax competition is inevitable.\(^11\) From this (not exhaustive) list, which does not has the intention to be fully complete, one item omits. This last type, \textit{i.e.} tax planning, is considered to be legal. In international context this could also be described as ‘tax arbitrage’ but this research will use the term ‘tax planning’. The distinction between the three previous described forms of reducing tax liability (apart from tax competition) is shown schematically in the following figure:

\[\text{Illegal} \quad \text{Legal}\]

\begin{center}
\begin{tabular}{c|c|c}
\hline
\text{Tax Evasion} & \text{Tax Avoidance} & \text{Tax Planning} \\
\hline
\text{"BAD"} Tax Fraud & \text{Fraus Legis} & \text{"GOOD" Quit smoking} \\
\hline
\end{tabular}
\end{center}

\[\text{Tax liability and penalties and/or jail} \quad \text{Tax liability} \quad \text{No tax liability No sanctions}\]

\hspace{10cm} 12


\(^9\) \textit{Ibid}. Merks also refers to the ECJ, which in his view does not make a clear distinction between the two types.


\(^11\) Van der Geld, J.A.G., Lecture on \textit{The Netherlands: a tax haven?}, Tilburg University, March 6 2012. Since ‘harmful tax competition’ is one of the other subjects of this Wintercourse edition, this thesis will not discuss this topic in detail. For an overview on this subject I may recommend the work of my colleague student Deidre Overweel.

\(^12\) Figure is derived from: Merks, P.F.E.M., \textit{Tax Evasion, Tax Avoidance and Tax Planning}, International Tax Review, Volume 34, Issue 5, p. 275.
However it should be noted that the distinctions between tax planning, tax avoidance, tax evasion and tax fraud often lie in the eye of the beholder and are therefore difficult to concern. From the aforementioned described menu of ‘doubtful tax aspects’ the relevant element for this research is tax planning (i.e. the structuring of the taxpayer’s economic affairs in fiscally the most favourable way) and more specifically aggressive tax planning.

Tax planning concerns structuring transactions using different tax jurisdictions, whereby the tax burden of a corporation is reduced compared to a purely domestic context. In particular multinationals may benefit from this tactic, since they have both the worldwide structure to benefit by the differences between tax systems on the one hand and the money to make benefit of it on the other hand. In order to minimize their tax burden they make use of the differences between tax systems in various countries. Therefore this research will focus on multinationals. Logically, this behaviour is completely legal as it acceptable to choose for the most suitable tax regulation. Moreover it is an essential part of business policy, vital for a company to stay alive in times of global competition. However, the crisis contributed to the discussion of the border line between legal and illegal tax planning. Hereby underwriting the principle of fair share. Tax planning may reach a point beyond which it cannot be tolerated within a legal system indented to conform to principles of justice. This point could in my view be described as the line between ‘tax planning’ and ‘aggressive tax planning’.

Aggressive tax planning is described by the EC as: ‘[...]the use of artificial operations or structures and the exploitation of mismatches between tax systems with the effect of undermining the Member

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15 The phenomenon ‘aggressive taxplanning’ also contains several degrees: see e.g. Happé, R.H., Belastingethiek een kwestie van fair share (pre-advice), Geschriften van de Vereniging voor Belastingwetenschap, No. 243, Kluwer, Deventer 2011, p.27 and Merks, P.F.E.M., belastingontduiking, -ontwijking en –planning (deel 1), MBB 2006/9, p. 341 et seq.
18 Kessler, W. & Eike, R., Back to BASIC – Stages of International Tax Planning or: Getting the Grip on a Rocky Road, Intertax Volume 35, Issue 6/7, p. 373.
States’ tax rules and exacerbating the loss of tax revenues’ [...]21 In the same Communication the EC announced that it will come forward with initiatives on tax havens and aggressive tax planning before the end of 2012.22

The OECD also highlighted the importance of combating this type of tax planning few months earlier: ‘aggressive tax planning – untaxed income, multiple deductions and other forms of international tax arbitrage – is a growing concern for all governments’.23 The Report was very much fuelled by a growth in loss-carry forwards (e.g. examples representing 25% of GDP in some countries) combined with the perceived or observed use of loopholes in avoiding double taxation. Furthermore this Report identifies three key risk areas, namely corporate reorganizations, financial instruments and non-arm’s length transfer pricing.

In tackling aggressive tax planning, there is lack of consensus on criteria and legislation between states. The best solution could be on an international level but bilateral solutions seem to be the ‘second-best’ and therefore more practical response. Despite the efforts made by the OECD, G20 and EU, these instruments are all of the nature of soft law, considered not to be effective enough to tackle the problems. The most problematic nature is caused by the use of different tax principles, e.g. the source and residence principle.

1.2 Principles

Hence aggressive tax planning travels from the overseas Source State (host country) to the Residence State (home country) of the taxpayer. Among these plans are the transaction costs, management structure, business risks as well as the relevant anti-avoidance measures.24 This part underlines the debate and focus on international business taxation. This term has become the object of debate in recent years.25 In a more specific way, the allocation of tax jurisdiction between residence and source countries is challenged,26 if not completely eroded by globalization (in particular e-commerce).27

21 EC, On concrete ways to reinforce the fight against tax fraud and tax evasion including in relation to third countries (COM 2012, 351), Brussels, 27 June 2012. p.3.
22 Ibid. at 13.
This challenge and the above mentioned existence of obstacles and disparities is not surprising, since the earlier mentioned formula was developed back in the 1920s. The League of Nations (the processor of the OECD) drafted the first Model tax conventions on income and capital in 1928.28

It can be stated that today’s international tax systems (international income and capital gains) of nearly all democratic constitutional states are based on ‘the 1920s Compromise’.29 This compromise finds its roots in the years after World War I. The high tax rates sharply focussed the attention on the potential chilling effects of double taxation and spurred a movement dedicated to its elimination.30 This movement during the 20s led to international consensus, sometimes referred to as ‘the 1920s Compromise’.31 The aim of the compromise was the proper division of the jurisdiction to tax income derived from cross-border transactions. Under this compromise the jurisdiction to tax active business income is accorded to the source country, while the jurisdiction to tax passive investment income (or: portfolio income) is accorded to the residence country.32

Therefore it is recommended integrating common tax principles into a global tax system. Despite recent proposals like the CCCTB, this uniform tax system is considered to be a utopia.33 Hence combating this type of tax avoidance (i.e. aggressive tax planning) requires coordination: union is strength.34 In this respect, harmonization is the ultimate goal, but seems not to be feasible.35 Hence small steps should contribute to this development.

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29 These models, as modified from time to time, have served as the common basis for more than 1700 bilateral income tax treaties now in force throughout the world, compare also, e.g., U.N. Conference on Trade and Development, World Investment Report 1998: Trends and Determinants xix, 1998.
35 In the view of the European Commission.
Thus harmonization in international direct taxation seems to be unrealistic; it was simply mentioned by the OECD for the sake of completeness.\textsuperscript{36}

1.3 Indirect taxation

Principles in taxation are also to be found in indirect taxation, since in general taxes can be divided in both direct and indirect taxes. Therefore the principles of indirect taxation are also to be investigated in this research. With respect to harmonization, in the field of consumption taxes more progress has already been made.\textsuperscript{37} Although consumption taxes are generally very different from direct taxes since the construction and aim vary, both taxes are based on economic activities containing outgoing and incoming transactions. Also in the field of cross-border transactions there is much to gain from an exchange of knowledge, although different principles are applied. One might learn from another with respect to the progress made in the consumption taxes and in Value Added Tax (hereinafter: VAT) in special. Therefore, this research will investigate also the principles of the VAT system, focussing especially on anti-avoidance.

Within the European Union an internal market without internal frontiers already has been established, this could be an example for the rest of the world. The main theme of the EUCOTAX 2012 therefore is: ‘from national towards global tax systems’. This sounds like utopia, but might be the case in the future. The current situation is one of deficiencies in the current different tax models. These models simply do not unanimously apply the rules with respect to e.g. aggressive tax planning. Some countries grant a tax credit while other applies a tax exemption. Other examples are the, with respect to aggressive tax planning, weak principles of residence and permanent establishment. From the perspective of anti-avoidance via aggressive tax planning this research will try to seek on which principles the future ‘global tax system’ should be based upon. The fiscal sovereignty of nation states is limited to activities that take place within their territory, making it a domestic matter.

The combination of a globalizing economy and the geographically restricted fiscal sovereignty of states lead to problems, like in this respect double non-taxation, in the allocation of tax among taxpayers and between states. These problems are among others due to obstacles, disparities and the inadequate ‘formula’ that is generally used by states to divide the ‘international tax pie’.\textsuperscript{38}

\textsuperscript{36} OECD, Hybrid mismatch arrangements: tax policy and compliance issues, OECD report, 5 March 2012, p.13.

\textsuperscript{37} With the Sixth VAT Directive as the EU wide introduction of a broadly identical ‘VAT base’, Directive 77/388/EEC

1.4 Aim of the research

This research hopes to contribute to an answer on the question how these problems (with respect to the taxation of corporate business income in a global market) which result double non-taxation can be dissolved via the way of principles. Therefore this research aims at investigate these principles with respect to their sensitivity for aggressive tax planning.

Since the G20 and OECD developments, how good they may be, are still reactions on developments inside the tax advisory field. What I try to say is that we must try to be first in this game, and not merely react. Therefore it is necessary to have a closer look on the current systems and her principles, what we can learn from them when developing a more global tax system.

Therefore I hope the key findings of this paper will result in relevant principles on which future global tax systems could rely on, either via principles of indirect or direct taxation. To verify these principles, this research will analyze and evaluate the role and position of the relevant principles of international tax and their sensitivity for anti-avoidance and more specifically aggressive tax planning. It will be based on EUCOTAX countries law, tax treaties and European Law. The problem statement to examine is the following:

“What are the relevant principles in international taxation in both the EUCOTAX countries laws and in VAT, and on which principles should the development from national towards more global tax systems be based on in order to combat aggressive tax planning?”

In order to come to an answer, the following chapters discuss the following sub-questions:

- What are the principles in taxation and which are the relevant principles for this research? (Chapter 2)
- What are the relevant underlying principles of the VAT system? (Chapter 3)
- What are the relevant underlying principles of international direct taxation? (Chapter 4)
- What are the relevant underlying principles in the EUCOTAX countries? (Chapter 5)
- What are the most relevant principles for combating aggressive tax planning underlying both VAT and international direct taxation? (Chapter 6)
Thus the key findings from these chapters will be discussed in chapter six, which finally lead to conclusions and recommendations in chapter seven. The information in this research is primarily based on developments in the EU, which is considered to be a unique concept in the entire world. But the EU is build on notions of twenty-seven developed states, thus making it not a unique concept.

Therefore I do believe that the experiences in the EU may also have meaning outside its geographical area, since I believe that this could be conceptually the same for developed states outside the EU area. The supranational EU applies within the ‘rest of the world’, but is also part of it – ‘the world is the world’.  

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39 Quote is derived from E.C.C.M. Kemmeren, Symposium on Tax Justice, Dutch Senate, 17 June 2009.
2. Framework

2.1 Principles in taxation

Principles and standards are the umbrella that governs the law. With national systems moving towards a global system, the principles governing international taxation must first be recognized to apply such national systems in a globalized world and to avoid problems such as double taxation and non-taxation. From a wider perspective, and as will be discussed further in this paper, principles such as democracy, the rule of law, representation and sovereignty must always be taken into account in moving from purely national tax systems toward a global tax system. In general, common principles need to be taken into account when creating any kind of global systemic tax to address the current financial crisis or any other systemic risks.

In the previous section the correlation between current issues of tax avoidance and fundamental failures in the system of taxation has been set out. In chapter two of the research provides a theoretical basis for the position that the application of principles to the current problem is justified. The first question which arises is what exactly the principles in taxation are. In a more specific way the question be answered what the relevant principles for this research are should be answered. The latter question will be discussed in section 2.3. To be able to investigate the principles in taxation, the term ‘principles’ should first be defined. Unfortunately, this can’t be done via the Code. However, in the literature there are several ways developed to discern how the concept of principles is to be conceived.

2.1.1 The definition of principles

The topic of this research is ‘Principles and standards in transnational taxation’. The Financial Stability Boards defines standards as: ‘Standards set out what are widely accepted as good principles, practices, or guidelines in a given area’. \(^{40}\) They can be classified by their scope: sectorial or functional. From implementation perspective standards differs in specificity principles, practices and guidelines. Principles are defined as ‘[...] fundamental tenets pertaining to a broad policy area. Principles are usually set out in a general way and therefore offer a degree of flexibility in implementation to suit country circumstances [...]’. \(^{41}\) Principles are for the purpose of this research taken to be the fundamental tenets or primary assumptions forming the basis of a chain of reasoning. \(^{42}\)

\(^{40}\) Compare: http://www.financialstabilityboard.org/cos/standards.htm

\(^{41}\) Ibid.

\(^{42}\) Online Oxford English Dictionary, last accessed January 2012.
A general principle is thus a widely accepted standard, broad in its speciality and offers a possibility of flexibility. In the field of law in general, principles are to be considered as expressions of legal values, which constitute the normative foundation of law in general.43

2.1.2 Principles as optimization requirements

Principles as ‘optimization requirements’ basically refers to the application of principles in the legal system. For this research the role of principles in the society is of more value than the role of principles in the legal system. However this point of view could be used to clarify some points in the broader context of principles. Therefore this is the aim of this section.

Norms can be divided into either principles or rules.44 The discussion about principles versus rules is absolutely not new.45 The legal system is built on both principles as rules. According to Dworkin, these two types have to be seen strictly apart, as they have different approaches.46 Rules do have an ‘all-or-nothing ’character, or ‘check the box’: they simply apply or don’t apply.47

In other words: a rule has a pre-defined scope since it has been enacted by a certain authority that defined its scope in advance.

In contrast principles do have an unlimited scope, which can only be determined in confrontation with another norm. Therefore they simply lack the resources to determine their own extent.48 Principles just put the weight and propose a reason for a decision.49 According to Dworkin this last sentence is fundamental, as it’s the clear relevant distinction from rules versus principles. Thus, the latter does have this type of character what the first lacks: the possibility to put the weight.

Hence there is enormous literature on the philosophical debate on rules and principles and many rejected Dworkin’s distinctions.50

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45 Compare also, *e.g.*, Avery Jones, J., *Tax law: rules or principles*, British Tax Review 580, 1996.
49 Happé, R.H., *Belastingrecht en de geest van de wet; een pleidooi voor een beginsel-benadering in de wetgeving*, Rede uitgesproken bij afscheid als hoogleraar aan Tilburg University, Tilburg, 2011, p.36.
Several benefits are claimed for the use of principles over rules, whether principles can achieve these advantages depends on what we mean by principles and how well this concept is applied. The theory of Dworkin is, in this way and commonly, applied *mutatis mutandis* on taxation.\(^{51}\) However this may be questioned. Edwin Simpson for example has suggested that a principle approach to taxation is not really ‘Dworkian’.\(^{52}\) I do agree with Freedman that in the pure sense Simpson is right.\(^{53}\) However this item will be further discussed in chapter seven.

Alexy’s theory of principles distinguishes principles from rules via an example of this can be seen in Court: a conflict between the norms. If two rules conflict with each other, this could be described simply a leak in our legal system, as one of these rules has to be set apart via for example an adagium such as *lex posterior derogat legi anteriori*. On the other hand the decision of the judge could be an outcome of the weighting of principles. This is not the result of disapplying one of the principles, but of realizing both of them within what is legally and factually possible. This could be defined as a process of optimization, whereby the optimum position between both principles is established.\(^{54}\) If a principle and a rule collide, the process is similar: a principle could limit the scope of the rule and vice versa the rule could limit the scope of the principal.\(^{55}\)

As mentioned in chapter one: the distinction between ‘unacceptable’ and ‘acceptable’ tax planning is critical. The majority of the countries recognize the right of the taxpayer to arrange his affairs in a way which seeks for minimal tax liability.\(^{56}\)

Terms like ‘tax evasion, ‘tax avoidance and ‘tax competition need to be certified.\(^{57}\) It is clear that the above mentioned steps are a good development in the right direction. However, the way the development is done is via new rules. Rules can be developed in different ways. Thus, the type of rule which is used matters not least because it’s affect people’s behaviour.\(^{58}\)

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51 Like *e.g.*, Avery-Jones, J., *Tax law: rules or principles*, British Tax Review 580, 1996
55 Apart from the exception which may apply in certain jurisdiction, which may prescribe that a rule which has been enacted by a competent authority cannot be overridden by a court that is applying a certain principle.
58 Different types of rules also involve different costs and benefits, which may be differently distributed between legislator, regulated firm and the beneficiaries of the regulation, discussed further, and for other, less direct reasons which can be related to defining the institutional position of the legislator: compare Black, J., *Rules and Regulators*, Oxford: Clarendon Press, 1997, pp. 91-108.
Various research in tax, accounting et cetera shows that whether a rule is detailed or general (a principle), combined with the consequences of breaching the rule, have a significant effect on how people respond to the rule.\textsuperscript{59}

Thus aggressive tax planning is not in conflict with the letter of the law; however it is in conflict with the spirit of the law.\textsuperscript{60} Principles put also relevance with the spirit of the law, as they are fundamental and reflect our society. The current tendency in our society on the practices of multinationals, who evade lots of taxes via aggressive tax planning, suggest the increased urgency to combat this. Principles cannot neglect this.\textsuperscript{61} The spirit of the law will be further discussed in chapter seven.

2.1.3 The relativity of principles

It should be noted in the framework that all principles are relative; none of them can claim to be absolute. This could be explained from the fact that principles are related either to individuals or groups of individuals. In the first case principles are related to rights while in the latter they are related to collective interests. In this manner the term ‘absolute’ contradicts with the possibility for a principle to relate with individual rights of public interests. This is exactly what Alexy try to mention with the conclusion that absolute principles are either incompatible with individual rights or can apply to only one person.\textsuperscript{62} In the case of individual rights the application of an absolute principle will result in a conflict with itself if the right it protects of a individual collides with the similar rights of others. In such case the latter must pass away, which is inconsistent.\textsuperscript{63} The same applies to the case of collective interests; as a result constitutional rights of others would be non-existent in this area. This does not mean that principles cannot have the appearance of absolute principles.\textsuperscript{64} However the conclusion is that principles are by their nature relative.\textsuperscript{65}


\textsuperscript{61} As this is considered to be the open system of law: \textit{i.e.} the interworking with the society. Compare: Happé, R.H., Drie beginselen van fiscale rechtsbescherming, Kluwer, Deventer, 1996, p.80 et seq.


\textsuperscript{63} Douma, S.C.J., Non-discriminatory Tax Obstacles, EC Tax Review 2012-2, p. 68.

\textsuperscript{64} \textit{Ibid.} Douma mentions the theory of Alexy who argues that the more a principle is restricted, the more ‘resistant’ it gets. In that case the strength of the countervailing principles has to grow disproportionately. According to Alexy this is corresponding to the ‘law of diminishing marginal utility’, \textit{i.e.} that there are conditions under which it is almost certain that no other principle will apply; however the level of certainty herein is a result of the relation of the different interests involved: Alexy, R., A Theory Of Constitutional Rights (translated by Julian Rivers), Oxford, Oxford University Press, 2002, p. 195.

\textsuperscript{65} \textit{Ibid.}
2.1.4 Historic overview of principles

The debate on principles is often used in the context of formulating and implementing of a tax system. From this debate the underlying question is: ‘what is the best form of tax?’ This debate already started in the United Kingdom by a former customs official, Adam Smith in *The Wealth of Nations* (first published in 1776). Smith set out four ‘canons’ that, in his view, lead to better taxes. These canons still influence official thinking today, of course in modified form. According to Smith, the four axioms are: people should contribute taxes in proportion to their incomes and wealth; taxes should be certain, not arbitrary; taxes should be levied in the most convenient way and the costs of imposing and collecting taxes should be minimal.

Personally I do agree with Morse and Williams who argue that a modern canon should be added: ‘taxes should be both convenient and competitive internationally’. Of course, at the time of Adam Smith the level of international trade was developed on a very limited scale, while the concerns on the allocation of tax jurisdiction were on an even more minimal level. The main concern of tax related issues in international trade is double taxation.

Today the OECD Model seeks to provide a uniform method for the resolution of most frequently occurring problems arising in international juridical taxation. Although it should be noted that a tax treaty serves more purposes: *i.e.* prevention of tax avoidance and tax evasion, elimination of discriminatory taxation, and sharing revenues between contracting states.

Although the OECD Model is not binding, many treaties conform to it, including those which are non-OECD countries. As discussed in chapter one, the OECD Model has its origins in the work of the League of Nations in the 1920s and 1930s. The work of the League of Nations on international taxation at that time is considered to be impressive.

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The League of Nations developed its first bilateral treaty in 1928, and its final models were the Mexico Convention (1943) and the London Convention (1946). However, it has been concluded that the main contribution of the League of Nations was the use of ‘classification and assignment’ structure as the structure for its model tax treaty. Since the same structure is used in current tax treaties, the OECD Model and the UN Model respectively.

**The development of principles in the Netherlands**

A brief introduction to the development of the debate on tax principles from a Dutch perspective could provide some ‘feeling for the background information’. Such introduction should start with Polak en Van Gijn, who did point out their views on the ‘General principles of levying taxes’ in two well-known pre-advises (recommendations) for the Dutch government. Van Gijn was looking for a synthesis between the principle of ability to pay (derived from the 19th century) and the changing views on the tasks of a state. His economic perspective was remarkable. As a result he distinguishes three categories of general principles for the levying of taxes: financial principles, economic principles and principles of justice. In these principles the principle of ability to pay remained the leading principle, which refers to an economic conceptual framework of equal utility sacrifice.

Taxation at that time was primarily an economic issue of equal utility sacrifice, this is also called ‘fiscal isolationism’. Polak on the other hand, speaks of the ‘relative’ nature of the tax theory: they arise in in certain societies where the place and time differ. In this theory (of Polak) we can get a glimpse of the proposition that principles in taxation cannot claim universal validity. This theory was later developed by Van Berge in 1949, while Hofstra tied later to this view.

In summary it can be stated that the dominant perspective during the nineteenth century on tax theory became a more of ‘the hands tied’. The fact that tax law was also a matter of law in general and therefore founds it boundaries in this general law, has not yet been developed. This period lasts until the late 20’s of the twentieth century.

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76 Ibid, at 490.


This connection to law in general was exactly what Hofstra was aiming at: to not to isolate tax theory and thus to leave fiscal isolationism. The ideas about the ability to pay are outdated, even the ideas of among others Smeets and Adriani, who already limited the principle of ability to pay to a few taxes, and are not radically enough in Hofstra’s view. Therefore the justice of taxes should first be ‘seen in the light of the legal system as a whole’.

At the same time taxation should be considered as being part of both the economic and social policy as a whole, implying that also other goals besides pure fiscal could be adhered. These are the goals for a new system of new principles for taxation, according to Hofstra. Hofstra doesn’t succeed in defining this principle yet, but this will be done in the future. The result of the principle of ability to pay doesn’t need to be abandoned, as long the legislator will not become a slave of this theory.

After the Second World War the tax science continued its research on principles. Van den Berge hereby played a role, which was in the line with Hofstra’s previous mentioned remarks. In Van den Berge opinion it was clear that the legal basis and therefore the relationship to the law (according to the admonition of Hofstra’s fiscal isolationism which had to be leaved) were strongly emphasized. He also made a sharper distinction than previously made between legal and effectiveness principles.

In the upcoming 50’s De Langen distinguished in his lecture entitled ‘Fundamentals of our tax system’ seven basic principles in tax law. This systematic application was based on the empirical-analytical method of Kranenburg. At that time such approach was only applied to criminal law.

De Langen distinguished this sequence: the principles of equality, ability to pay, preferential procurement, benefit, welfare, least suffering, and the principle of lawful execution. However, this method has been heavily criticized.

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79 Hofstra, H.J., *Inleiding Nederlands belastingrecht*, Kluwer, Deventer, 1992, pp. 95-98. In the authors view the principle of ability to pay was more like a ‘leave them as you find them’ idea of a neutral state.
80 Ibid., at 63.
87 Compare e.g. Niessen, R.E.C.M., *Inleiding Nederlands belastingrecht*, Fiscale Handboeken, 9th version, Kluwer, Deventer 2010, p. 56. The criticism is based on earlier Hofstra’s comments in previous versions of the book. In Hofstra’s view, this method was ‘a motley collection of principles without taking pains to create order’.
It can be concluded that this approach is not suitable to determine principles, as they are ‘utility and regulation standards but no legal principles, and therefore no tax principles’. According to Gribnau et al, the debate between Van den Tempel en Hofstra in 1979 can nowadays be considered at the end of this discussion. The conclusion was that tax law has its own principles which have to been seen in a wider perspective. This development is a good start for the description of the principles in taxation, which have to be seen in a wide perspective, both from the economic and from the law perspective. The lesson to be learned from this section is that principles have to be evaluated in the broader context and claim universal validity.

**Conclusion**

The previous section is one of a abstract nature, which is not the aim of this research. However for a ‘full picture’ approach this nature should not be neglected. Thus it contains to be quite abstract. De Langen amongst others is very in favour of specific tax principles, although there are several authors who deny this. These authors argue that there is ‘just’ a ‘set of principles’ and therefore specific tax principles simply doesn’t exist. For example the principle of lawful enrichment, which is mentioned by De Langen, is also known as the paradox of equality.

The idea of keeping everything general cannot be associated with the idea of keeping everything equal. This is also a discussion on ‘optimization of principles’ by Alexy and contemporary translated into the dissertation of Douma. The latter is looking for a balance between legal theory and principles, what is not the aim of this research. The conclusion of this part is that in international context rules are limited; the international legal system is absent. Therefore principles should be of more value, whereby the judge could take the role of the legislator.

This is not the place to discuss all these items in detail; however in my opinion this underlines the relativity of principles. The aim of this research is to discuss principles in the context of international taxation, which makes it possible to discuss since in this respect there’s a benchmark (i.e. international trade and more specific aggressive tax planning).

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2.2 Principles in this research: level based

In section 2.1 the structure of principles has been set out. The current section aims at establishing a legal framework for the relevant principles for this research. The relevant principles will be set out in section 2.3. First the principles of taxation have to be clarified. The starting point can be derived from the first chapter: the selected principles should have relevance to the allocation of tax jurisdiction in the light of aggressive tax planning. This discussion on ‘principles in international taxation’ is a heavily debated subject, without a unanimous ‘winner’.91

As a result, this research can’t follow ‘the proper way’ as this way omits, but aims at determining and evaluating the various relevant theories. As previously mentioned there is not a ‘general approach’, thus opinions contain to be very different. This research will discuss some of these opinions which are relevant according to the author. The last ‘warning’ is that principles are always relative.

This research will make use of a level-based approach. The term ‘principles is taxation’ is that broad that it is difficult to clarify this. As a result a level-based approach will be more suitable to provide some clearance in this field. In my opinion this is possible.

For this research the principles are divided into three levels. Although this distinction may be debated, in order to provide basic clearance in the abstract field of ‘principles in taxation’ this is the approach of the research (since researches are more or less obliged to choose an approach).

The first level contains of the general legal principles, *i.e.* justice and equality, which are commonly accepted as fundamental.92 The second level is titled, with respect to international taxation, ‘the interchangeable principles’ of equity and efficiency. This definition can be clarified via *e.g.* Kemmeren, who points out that worldwide economic efficiency is maximised by allocating production factors where they earn the highest income or return (in order to increase worldwide prosperity). However, he adds that apart from this efficient creation of income, worldwide prosperity also depends upon an equitable distribution of income.93

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The third level contains general accepted specific tax principles, the benefit and the ability to pay principle. They are used in the sense of being underlying principles for allocating tax jurisdiction.

A deep examination of the advantages and shortcomings of each principle is unfortunately not possible in this research; this section is limited to a brief overview of each principle based on the authoritative opinions of scholars. In this respect the 'international tax law arena' will function as the relevant environment, as the question whether internal tax systems should be based on this principle is beyond the scope of this research.

2.2.1 First level: general legal principles of international taxation

2.2.1.1 The Principle of Justice
The first general legal principle is the principle of justice, which is clearly summarized by e.g. Tipke and Lang. This article is based on a contribution to the Liber Amicorum in Honour of Professor dr. Joachim Lang, of Cologne University. In this contribution Joachim Lang is described by Vanistendael as ‘the one who has written extensively on issues of justice in taxation’. Thus the basis for all the principles in taxation is, according to Lang, the principle of justice. Therefore this analysis shall be used as starting point of this research, which seems to me as ‘justified’.

Formal part
The authors divided it into two parts: first, there is a number of principles of formal justice, which do not apply to all taxes, but which also may be applicable to other areas of law. These principles are: legal certainty, legality, specificity, non-retroactivity, the prohibition of analogous application and the legitimate trust in public authority. These principles have a common letter that they do not directly affect the score, base or rate of a tax.

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95 In similar way: Kemmeren, E.C.C.M., *Source of Income in Globalizing Economies: Overview of the Issues and a Plea for an Origin-Based Approach*, Bulletin for International Taxation, November 2006, p. 431. Who states that: ‘it should be noted that the (direct) benefit principle is used here merely as an underlying principle for allocating tax jurisdiction among states’.
97 Ibid.
Hence designing tax law require a legal basis, which is clarified with respect to the principles of taxation. The next step will be the definition of the fundamental principles of taxation. General principles are the central source for the law and may have a compulsory influence on for example both the tax inspector as the taxpayer. In Western Europe and North America, modern tax systems developed during the half century that followed the American and French revolutions.

Thus, the middle of the nineteenth century the basic legal framework was established. To have a general overview of the relevant principles in a tax system, this is a good starting point. The rule of law should be in accordance with the fundamental legal framework. Hence the objective of the rule of law is restraining political power. However it is not a self-operating system; therefore it has to be effectuated by the government.

The first basic of this ‘rule of law’ framework is that, a tax can only be levied if a statute lawfully enacted so provides; secondly a tax must be applied impartially, and lastly the revenue raised by tax can be solely used for lawful public purposes. Independent courts will enforce these principles, according to the rule of law. The rule of law requires a democratic state, where legislation must respect the fundamental right of people to equal treatment. Since it is in the nature of laws to classify or discriminate, the principle of equality is inevitable and demands ‘treating like alike’.

The principle of the rule of law is also closely linked with the principle of legality, i.e. any tax must have a firm basis in law. No tax can be levied without authority of the law. The rule of law aims at protection against arbitrary interferences. This is connected with the principle of representative democracy, which said in other words: ‘no taxation without representation’. In this respect a exception is the minimum tariffs of the VAT as well as the customs tariffs which are proposed by the EC and decided by the European Council of Ministers. The principle of legality is very close connected to the principle of certainty of law. Both principles of formal nature relate to the rule

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103 Ibid.
104 Ibid.
105 Ibid.
106 Ibid.
108 Magna Carta, 1215, also Petition of Rights, 1628.
of law. From the principle of Legality, some countries derived two other principles: the principle of annuality (tax law can only have effect for one budgetary year) and the principle of ‘non-agreement’ (tax administration may not conclude an agreement on tax liability with the taxpayer).

The above mentioned principles are of a different nature as the principles which are relevant for this research, but not less important. Therefore they will be mentioned in section 2.2.5 as the ‘formal part’.

Material part

The other part of the principle of justice described by Tipke and Lang, consists of the material principles applying to taxes which form the basis for the justification of taxes. Besides this function, these principles are also used to justify the particular distribution of a particular tax burden. However, other authors can distinguish from the principle of justice several general principles, for example: legal certainty, equality, impartiality and neutrality. These observations will not be part of this discussion. What is commonly accepted is that Justice in taxation is commonly used in the meaning of fairness.

Vanistendael summarized in his contribution to the Liber Amicorum in Honour of Professor dr. Joachim Lang of Cologne University, seven principles under the ‘umbrella of material principles from the principle of justice’. Although his article was focussed on income tax, these principles are in my view the same for corporate tax. These are the principles of: budgetary, public benefit, equality and ability to pay, redistribution of income, social merit or utility, and distribution according to need. The budgetary principle is the general justification for all taxes, limited by the rule of law. The principle of public benefit on the other hand, justifies taxation on the basis that taxpayers benefit from government activities. This principle answers the question of whom and what to tax, rather than how to tax.

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114 Ibid.
Kemmeren e.g. advocates that the principle of justice is leading in the discussion on the right to allocate tax jurisdiction with respect to bilateral tax treaties, or in other words: equity is to be considered as the most important legal principle with respect to the allocation of tax jurisdiction.\textsuperscript{115} In international context, it is used to justify not only the taxation of resident or national taxpayers, but also foreign taxpayers, who undertake economic activities in other countries than their country of residence or nationality. In my opinion, this public benefit principle is similar to what Kemmeren means with the ‘direct benefit principle’.\textsuperscript{116}

The principle of equality is described as the dominant principle of justice in the area of taxation, which is a much wider principle than just a tax principle and which has been incorporated into many constitutions after the declarations of the American and French revolutions.

As this is mentioned by Vanistendael as dominant, this principle will be further discussed in section 2.1.1.2. In his article, Vanistendael uses the equality and the ability to pay principle as a pair. The latter will be further elaborated in paragraph 2.2.3.1.

The principle of redistribution of income can only be considered to be real principle of taxation in the sense of changing the primary distribution of income in existence before taxation.\textsuperscript{117} Tipke and Lang justify the progressive tax rate on the basis of this principle, from what they call the ‘Soczialstaatprinzip’.\textsuperscript{118} The principle of social merit (or utility) in practice is achieved by granting subsidies, but instead of providing direct cash subsidies, lawmakers often prefer to use indirect tax incentives. This principle cannot be considered as material principles of just taxation, in many cases these tax incentives destroy the overall material principles of justice like equality, ability to pay and social cohesion through redistribution. The last principle, according to need, is sometimes used as principles to determine justice in taxation, often as an argument for redistribution.\textsuperscript{119} However, this principle is also not suitable as taxation on its own cannot guarantee (re)distribution in accordance with need. Concluded can be stated that form the principle of justice only the principle of equality is suitable for considering to be a general principle in taxation, whether or not in combination with the ability to pay or direct benefit principle. However in the ‘level-based’ approach where this research is build on, these principles are set under the denominator of ‘allocation principles’.

\textsuperscript{116} Cf. Kemmeren, E.C.C.M., supra note 17, at 22.
\textsuperscript{118} Tipke, K. and Lang, J. Steuerrecht, ein systematischer grundriss, Cologne: Otto Schmidt Verlag, 1991, no. 3.5, p. 55.
\textsuperscript{119} Vanistendael, F. Is Fiscal Justice Progressing? Bulletin for International Taxation, October 2010, p. 528
2.2.1.2 The Principle of Equality

Like previously mentioned, the principle of equality is part of the principle of justice. The principle of equality is described as the dominant principle of justice in the area of taxation, which is a much wider principle than just a tax principle and which has been incorporated into many constitutions after the declarations of the American and French revolutions. From this constitutional significance it adheres exceptional protection, e.g. in some countries taxpayers have the opportunity to go to Court on the grounds of this principle. The current definition of the principle of equality is largely determined by the relationship between taxation, democracy and the rule of law. The idea is that taxation needs democratic legitimacy, which represents the citizens and is thus considered to serve the principle of equality.

The principle of equality treatment alias ‘equality’ applies to all laws; therefore it can be defined as being one of the main and predominant general principles. According to De Langen this is the first principle of the list. This principle demands that ‘treating like it is alike’. Furthermore, this principle implies and accepts different treatment of different situations on the other hand. When there is an objective or reasonable justification for the raised inequality, prohibited discrimination is not applicable. However, according to Vanistendael, also a procedural meaning is in it: ‘the law must be applied completely and impartially, regardless of the status of the person involved’. This application is one which includes all persons who are similarly treated with respect to the purpose of the law and that this will also be performed. Tax law must, like other laws, conform to the principle of equality.

The major expression of the principle of equality in taxation has been the principle of ability to pay. This principle also has been incorporated explicitly in several constitutions. This implies in international context that each jurisdiction has the right to tax from services rendered or benefits provided. In other words: each beneficiary of State expenses in services should pay their fair share (i.e. tax) for it (see chapter 6). This ‘benefit theory’ is similar to what Kemmeren argues with

126 Ibid., at.1.
'sufficient economic relationship', which have to be present to assess whether a sufficient point of the assignment of tax jurisdiction is present; therefore there have to be a linkage between the 'territory principle' with the 'direct benefit principle'.

The latter principle, the direct benefit principle, has been further elaborated by Bruins et al. In their view the direct benefit principle is both part of the 'faculty principle' as of the principle of ability to pay, since a person's wealth provides him or her the ability to pay taxes. Instead of the term 'ability to pay', the literature prefers the term 'faculty' as the first might only refer to income taxes. The faculty principle implies horizontal (similar economic situations – similar treatment) and vertical equality (different economic situations – different treatment).

Coming back to the first demanding: 'treating like it is alike': this can be seen as the substantive meaning of the principle of equality and thus for this research the most relevant. This suggests in my opinion that the principle of equality can be used merely the same as the principle of non-discrimination.

On a European level, the general prohibition of discrimination is stated in art. 18 TFEU. The Court of Justice recognizes the equality principle under the fundamental freedoms in cases where the TFEU applies. Firstly, the market equality could be mentioned: in this case, all economic operators may rely on being subject to the same national tax rules for market participation in the domestic markets of the respective EU Member States, irrespective of their place of residence. If a Member State violates this principle, this would be considered as an obstacle or discrimination. According to the Court of Justice, residents and non-residents are in comparable position as soon as a Member State exercises its fiscal sovereignty over them.

For tax purposes, this means that a non-resident deserves the same treatment to a resident by an EU Member State as soon this State decides to tax this non-resident. This entails that the economic operator’s place of residence should be of no relevance whatsoever when it comes to determining its tax burden in an EU Member State. However, this does not correspond with the residence principle as employed in the OECD and the UN Model Conventions on income and capital: limited tax liability

127 See Kemmeren, E.C.C.M., supra note 17, at 22.
129 Compare e.g. Ibid and Kemmeren, E.C.C.M, supra note 17, at 24.
for non-resident taxpayers versus unlimited tax liability for resident taxpayers in combination with
double tax relief.\textsuperscript{132}

EU law in the field of direct taxation does not imply the principle of equality unimpaired. For
example, the concept of ‘most-favoured nation treatment’ as an expression of the principle of
equality is never acknowledged by the ECJ.

In the context of inter-nations equity, the principle of equality is defined as the principle of non-
discrimination. According to some authors the difference between equality and non-discrimination is
more of a terminological nature.\textsuperscript{133}

\subsection*{2.2.2 Second level: interchangeable principles of international taxation}

International context implies the allocation of tax rights. In this discussion, two other elements are
necessary, \textit{i.e.} tax equity and tax efficiency.\textsuperscript{134} Basically, international tax theory starts with the
requirement that the allocation of tax should be\textit{ equitable} and\textit{ economically} efficient.\textsuperscript{135}

The distinction came from Richard A. Musgrave.\textsuperscript{136} Tax neutrality is considered to be an economic
aspect, while tax equity a legal aspect on the other hand. A consequence of this is that in respect of
determining the allocation of tax rights, both have to cooperate.

In the discussion which state should tax international income (and to what extent), both efficiency
and equity are called upon to cooperate.\textsuperscript{137} This deemed cooperation is the actually the starting point
of the friction between economic and juridical reality. A good example in this discussion is the
permanent establishment (hereinafter: PE), which can be seen as a compromise between both
ends.\textsuperscript{138} States that import capital and labour in huge amounts and who are willing to tax this prefer
taxation on the basis of economic reality, while in contrast states with huge amounts of exporting
capital and labour that are willing to levy tax on this export, support taxation on the juridical
reality.\textsuperscript{139}

\textsuperscript{132} See for a comparison Kemmeren, E.C.C.M., \textit{Renneberg Endangers the Double Tax Convention System or
\textsuperscript{133} Wilde de, M.F., \textit{Some Thoughts on a Fair Allocation of Corporate Tax In a Globalizing Economy}, Intertax,
\textsuperscript{134} See for a comparison Vogel, K., Part I, pp. 216-228, Part II, pp. 310-320 and Part III, pp. 392-402.
\textsuperscript{135} \textit{Ibid.}
\textsuperscript{136} Musgrave, R., \textit{Criteria for Foreign Tax Credit}, in: Taxations and Operations Abroad, Symposium, 1960, at
83.
\textsuperscript{137} Vogel, K. Part I, p.216.
\textsuperscript{138} Albert, P.G.H., \textit{Vaste inrichting en aftrek t.v.v.d.b}, TFO 2011/97, paragraph 3.2.
\textsuperscript{139} \textit{Ibid.}
2.2.2.1 The principle of Equity

The principle of equity is an extension of the principle of equality, since the latter aims at equal treatment while the first determines (e.g. in the case of individuals) the ‘fair share’ an individual should pay. Defining tax equity is more difficult than it seems like, to kick-off with a famous quote: “what ‘equity’ means cannot be defined [...], it can only be explained, paraphrased [...]. That is to say, unfolding what equity demands with respect to a particular situation implies an element of creativity [...]. Thus, though there is only one truth, there may be more than one answer to the question of equity.”\(^{140}\)

Starting with such quote might not be clever for your research; however it is good to mention the various aspects equity might have. Kemmeren \(e.g.,\) distinguish within the idea of equity three elements: legal equality, public interest, and legal certainty, whereby the mutual relationship among these elements should be in balance (which depends on place and time) in individual cases.\(^{141}\)

First of all tax equity implies equal treatment of the taxpayer. Other aspects of tax equity are based on fundamental values in the legal systems of the nation and the EC: social equity of the welfare state, freedom of property, the protection of the family by the state and the four freedom of the TFEU.\(^{142}\)

In the discussion of equity with respect to tax, the word ‘equity’ is often used as a synonym for the term ‘justice’.\(^{143}\) Another observation which can be made is that equity is a morel concept, based on the principle of equality.\(^{144}\) As a result, the line between equity and equality is not always easy to draw. In the literature, different opinions underline this, where equity and equality are used in a similar context.\(^{145}\) In line with this two other principles can be seen, as everyone in an economic relationship with a state has the moral obligation to contribute to the financing of public goods from which one benefits: benefit principle, which is in accordance with one’s means: ability to principle.

Equity is a moral concept, founded in the principle of equality. Equity within an international tax system requires that the level of tax should be determined by making reference to the public goods

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\(^{140}\) Vogel, K., Part III, pp. 393-394.

\(^{141}\) Kemmeren, E.C.C.M., supra note 17, at 20.


\(^{143}\) See Vogel, K., Part III, at 393.

\(^{144}\) See Vogel, K., Part I, at pp. 216-228 and Part III, at 393-402.

provided by the taxing state: benefit principle. If a corporation is present in a state, economically (if a certain minimum threshold is exceeded), they should contribute to the financing of public goods provided by that state, irrespective of their place of residence.\textsuperscript{146}

Examples of such thresholds applied by states in practice are the concepts of permanent establishment and the place of effective management. However, with respect to the tax burden of a corporation, it should be irrelevant where this corporation is established, according to the principle of equality, within the same line of the principle of equality; it should be also irrelevant whether this corporation wholly or partially realize business profits within a certain state or spread around several states.

In international tax context can according to the literature, within the term ‘equity’ two forms are distinguished: the so-called ‘inter-nations’ equity and the individual equity.\textsuperscript{147} Whilst the first refers to the gain and loss of the state of citizenship/residence and the state of source, the latter refers logically to the position of the individual taxpayer.\textsuperscript{148}

Individual equity is related to the fact that a tax system should be equal for her taxpayers, \textit{i.e.} on the basis of the principle of equality. Thus individual equity is based on the principle of equality.\textsuperscript{149}

Whereas this principle requires the equal taxation of people with the same income, regardless of source, thus based on their ability to pay; on the other hand it aims at the levy of progressively taxation in different income situations amongst taxpayer. From individual equity results both the ability to pay principle and the benefit principle. Corporations within the same border deserve the same tax treatment as both equally benefit from the same public goods provided; as they raise profit they should be liable to pay corporate tax to a certain amount. Furthermore the legality principle and the principle of legal certainty can be distinguished from the principle of individual equity.\textsuperscript{150}

Inter-nations equity, as the term suggest, is related to international contexts. In this context, each state should receive her fair share from international transactions related to their jurisdiction, as due to the lack of a supranational body with sovereign tax powers. Ideally, this goal should be achieved via tax treaties or negotiation agreements between states as equal partners with reciprocal


\textsuperscript{148} Ibid.

\textsuperscript{149} As first mentioned by Peggy Musgrave, \textit{Taxation of Foreign Investment Income. An economic Analysis} (1963). Cited by Vogel, K., \textit{Worldwide vs. Source Taxation of Income – A Review and Re-evaluation of Arguments} (Part III), Intertax 1988/11, 394. As Vogel mentioned, the citation of Musgrave has not to be taken literally, as she only followed US tax law without further discussion. However, It showed that a co-ordination of worldwide versus source taxation is not without problems under equality aspects.

appreciation of mutual tax rights. Reciprocity is considered to be one of the key principles in international taxation; it assumes that states have comparable social and economic backgrounds and fiscal needs. Inter-nations equity finds its normative foundation in the principle of equality, as the same is true for the individual equity. However, in the context of inter-nations equity, the principle of equality is referred to as the principle of non-discrimination. Again both the principle of ability to pay and the benefit principle ensue from this. Taxpayers operating domestically or abroad should contribute their share to the society, both in the domestic as in the other state. However, their contribution should be equal to the contributions of purely domestic taxpayers (in the same circumstances). Legal differences between states should not be an argument in comparing the treatment, as the sovereignty of states is a legal concept, just like the European Union. Domestic and cross-border business activities of taxpayers need to be compared, without taking the presence of the tax border which is a legal construct into consideration.

Lastly, the principle of equity requires the application of the single tax principle. This principle holds true in both domestic and a cross-border context, where in both cases it is unfair to tax twice the income earned by taxpayers. On the other hand (which is more relevant for this thesis): this principle holds that all income should be subject to tax once, not less. The single tax principle requires that income from cross-border transaction should be subject to tax once. The appropriate rate of tax for purposes is then determined by the benefit principle, which assigns the primary right to tax active business income to source jurisdictions and the primary right to tax passive income to residence jurisdictions.

In practice the principle of equity may be based either on the benefit principle or the ability to pay principle, while in practice it is commonly based on the latter (particularly on individuals). In other words: everyone with an economic relationship should contribute to the financing of public goods

152 Ibid.
153 Wilde de, M.F., Some Thoughts on a Fair Allocation of Corporate Tax In a Globalizing Economy, Intertax, Volume 38, Issue 5, 2010
from which one benefits (benefit principle) in accordance with one’s means (ability to pay principle). 158

2.2.2.2 The principle of Efficiency

Tax efficiency is the other important aspect regarding taxation. To achieve this efficiency objective, neutrality of taxes should prevail in open economies. 159 Therefore often neutrality is used instead of efficiency, although this is not correct. Tax neutrality relates to the relationship of the taxpayer with the state. 160 This concept is based on the assumption that productivity will be the highest when income producing factors are distributed by market mechanism without public interference, this is called tax neutrality. 161 Laws are neutral when they are not (or as little as possible) interfering and thus influencing market forces, as does tax systems. 162 Although tax laws will never be completely neutral, a high degree of neutrality should be sought. 163 Especially in the European Union, it is at least possible. 164 Like Vogel, this research will use the term ‘efficiency’ in the meaning of worldwide efficiency; however discussion on this point is possible. 165

Personally I believe that in a global market national efficiency and international efficiency go hand in hand. Striving for national efficiency entails striving for worldwide efficiency; therefore this should be a cornerstone for a state’s international tax policy. 166

The common sense in the literature is that efficiency enhances the concept of (international) tax neutrality. 167 Therefore it is generally assumed that not tax motives but only economic motives should be the basis for allocating production factors. 168

159 Kemmeren, E.C.C.M., supra note 17, at 523.
165 Vogel, K., supra note 31.
However, Peters among others argues that although equity considerations justify a deviation from the concept of international tax neutrality, they are not considered to be part of the concept, which in his view is a ‘somewhat imprecise assumption’ in the current globalized world.\(^ {169}\) As a result, this might have important consequences on the question who decides in the inter-nations equity discussion. Therefore efficiency should be distinguished from international tax neutrality.\(^ {170}\) Thus most authors don’t make this distinction and relate mutatis mutandis efficiency to neutrality.\(^ {171}\)

However, efficiency is determined to providing an economic foundation for a fair allocation of tax among taxpayers and between states.\(^ {172}\) Tax neutrality is founded on the principle of equality as well. Again, this means that the ability to pay principle and the benefit principle result from that. Corporations should be taxed equally; otherwise this would lead to distortions in the efficient allocation of production factors. Nevertheless, efficiency requires the neutrality of a legal form.\(^ {173}\)

Tax efficiency is about the efficient allocation of production factors, \textit{i.e.} where they earn the highest return. Therefore taxation should not influence business decisions. In an international context, in a event that a state exercises its sovereignty, the tax burden in that state on business income earned is always the same, irrespective of whether the business activities are performed solely in that state or spread out on several states, thus irrespective of place of residence. The ECJ recognizes neutrality as a cornerstone principle of EU Law. The TFEU provides that economic operators, can move their business activities freely between the domestic markets of the Member States, this is the so-called market neutrality principle.\(^ {174}\)

The tax treatment differs depending on whether the economic operator performs its business activities domestically or in a cross-border context. Obstacles imposed by Member States distort the functioning of the internal market, via for example exit taxes on businesses.

\(^{168}\) Kemmeren, E.C.C.M., supra note 17, at pp.69-70.


\(^{170}\) Ibid.


Tax neutrality

Taken in consideration the above mentioned, economists developed tow more limited forms of tax neutrality, whereby the focus is on capital movement and thus two effects of international allocation of production factors: Capital Import Neutrality (hereinafter CIN) and Capital Export Neutrality (hereinafter CEN). In short, these two forms aim at a neutral tax system as between investing at home or abroad (CEN) respectively at a neutral tax system between domestic and foreign investors (CIN). In practice, these two types are unanimously cited as to support rationale for adopting an exemption or credit system. However, both types omit the most important production factor besides capital: i.e. labour. Therefore the factor labour should also be supplemented to these two types. The famous distinction between CEN and CIN was invented by Richard Musgrave and his wife Peggy Musgrave, and has been discussed endless in the literature. This ‘battle of neutralities’ has never shows a winner. For example, neither the OECD nor the ECJ has expresses a clear preference for a particularly method, there is and will probably never be sufficient evidence on what form of neutrality is in the best interest for the international community.

Capital Labour Export neutrality

CLEN is understood to mean (form the state of residence point of view), neutrality of investment in the state of residence or in a foreign state. This state ensures that the total tax burden on investment abroad is the same as investment at home to ensure neutrality on capital outflows. The elimination of international juridical taxation is achieved by the credit method. Herein is the foreign source income currently taxed by the state of residence without any tax deferral, and full tax credit is given for any source taxes paid. In more broaden terms: CLEN aims at equality of competition between countries. In the field of direct taxes, CLEN is most efficiently obtained by worldwide taxation in the state of residence and credit being allowed there for the tax imposed by the state of source.

Capital Labour Import neutrality

Vogel, K., Part II at 311.
Kemmeren, E.C.C.M., supra note 17 at 71.
As only individuals can create income and things themselves cannot.
This is the recognition of Kemmeren, E.C.C.M., supra note 17, at 72.
Ibid., at 20.
Weber, D.M., supra note at 118.
Neutrality of investment made by a resident or a non-resident, is what CLIN requires. This from the point of view of the state in which the investment is made. This is achieved by the exemption method in its pure form, with respect to the avoidance of international juridical double taxation. It applies the same the same tax rate as residents on income derived by non-residents and does not impose any withholding tax on outbound payments. CLIN thus aims at equality of production factors.\(^{184}\) This type of neutrality is based on the idea that all investors in the tax jurisdiction will be subject to the same tax, regardless of their residence.

**Import vs. Export neutrality**

As mentioned before, both systems are discussed heavily and still have their own supporters, whereas the battle is never decided. However, there are some unanimous remarks that can be pointed out. Most economists in the 1960’s up through the 1980’s considered CLEN to be the form of neutrality which came most close the highest level of efficiency. The underlying idea behind this opinion was that tax motives can play an important role in the allocation of productions factors, thus resulting in shifting of economic activities. In turn, this results tax competition between states. Both consequences were regarded as being inefficient.\(^{185}\) More recent literature, economists and lawyers have argued against this opinion that CLEN is more efficient than CLIN.\(^{186}\) The fact that some economists don’t accept this shift is due to their ‘internal inconsistency in their reasoning about how to arrive at economic efficiency’; thus taking tax factors into account leads to a greater efficiency.\(^{187}\) Free competition should be adhered; also tax competition promotes efficiency of the world economy.

**Capital Ownership Neutrality**

Recently, the concepts of neutrality are enriched by the concept of capital ownership neutrality (CON). The perspective of ownership has been added primarily due to the reason that part of foreign investment is represented by the acquisition of existing assets by new owners. Capital-ownership neutrality would require that domestic tax laws on international transactions not distort the ownership patterns of assets. This would require an exemption system for payment of foreign taxes.

\(^{184}\) *Ibid.*


\(^{186}\) See Vogel, K., *supra* note at 216-229 and *supra* note at 310-320 and *supra* note at 393-402. Also Kemmeren, E.C.C.M., *supra* note 17.

The efficient allocation of the asset shall not be distorted by the tax burden. CON is satisfied if the tax system does not distort ownership of capital.\textsuperscript{188}

**Inter-nations neutrality**

As an alternative to CLIN and CLEN, several authors introduce the concept of inter-nations neutrality.\textsuperscript{189} Vogel argues that worldwide economic efficiency is best promoted when states do not employ their sovereign taxing power to influence the relative prices in other states. Pointing at the benefit principle, Vogel concludes that worldwide economic efficiency requires that an economic operator that performs economic activities within a state or a domestic market, and with that utilizes the public goods provided by that state, should be ensured that its tax burden is the same as any other who, in similar circumstances and to the same extent, utilizes the public goods provided by that state (inter-nations neutrality).\textsuperscript{190} Vogel argues that inter-nations neutrality can only be achieved by allocating the profits from cross-border activities to the geographic location where the economic activities actually take place and where the business income is produced: economic presence.\textsuperscript{191} This view only takes the benefit principle in consideration, not the principle of ability to pay.\textsuperscript{192}

**Capital neutrality**

New opinion in the field of neutrality is that of De Wilde, who argued that neither of the two most familiar concepts of neutrality, \textit{i.e.} CLIN and CLEN, achieves the objective aim of neutrality.\textsuperscript{193} This aim is the requirement that the tax burden that a state imposes on business income not vary based on whether the corporate taxpayer earns all of its income within the source country or not.

**National neutrality**

Supporters of this principle focus on maximising national welfare. A country following this principle does not credit a foreign tax paid on the respective income but solely allows the deduction from the


\textsuperscript{190} Vogel, K., Part II at 314. He refers to the connection between the benefit principle and the efficiency of the administrative machinery of government.

\textsuperscript{191} Vogel, K., Part II at 314.


\textsuperscript{193} \textit{Ibid.}
Therefore this principle is not be discussed further as economic efficiency should without any doubt to me, be pursued on a global scale.

The principle of Administrative convenience

In this second category the last principle to be discussed is the principle of administrative convenience. Administrative convenience can be considered as a synonym for simplicity. In a globalizing economy, obligations for taxpayer to provide information on their international business income, as well as agreements between states on mutual administrative assistance and cooperation, are of great importance. In other words: the administrative burden for the taxpayer is not reducing with the globalization, instead most of the times it is increased. Therefore simplicity seems to be the forgotten stepchild of the tax policy. In this perspective, administrative convenience has two sides: one of the taxpayer who is seeking for this in the assessment of corporate tax and of the tax administration, to comply with the law. However, administrative convenience is not of the same level as equality for example, as the Dutch Supreme Court did not consider this in assessing tax in cross-border scenarios as a justification for unequal treatment. For this research this will not be mentioned as a key-stone principle.

2.2.3 Third level: general accepted specific tax principles

Traditionally, economists have used two different principles for evaluating how the tax burden ought to be allocated: the ability to pay principle and the benefit principle. Although these principles are considered to be ‘aw-inspiring and time-honoured foundations of income tax in general’, they have a link to the principles of how to allocate taxing rights internationally. In essence, these principles should reflect the justification to tax in a domestic setting.

It should be noted, in this context, that the principles herein used as underlying principles for the allocation of tax jurisdiction amongst states. In this respect, both the principle of ability to pay and the benefit principle as well can be considered as general accepted specific tax principles.

Economists tend to base source taxation on the benefit principle, as Musgrave asserts that source taxation is based on economic benefit. In contrast, the residence principle would be based on the ability to pay principle. However Kaufman contends that source taxation is not based on the benefit theory, but that source countries have the legal right to tax income sourced within their borders under international law.

2.2.3.1 The principle of ability to pay

The principle of ability to pay is deeply rooted in our society, since it is a citizen’s contribution to this society by reason of solidarity. This principle, which is strictly connected with the principles of equality and equity, requires that within a country taxation should be levied according to the taxpayer’s contribution to the public spending. It is emerged from the principle of equality, thus it has not to be seen as an alternative. The major expression of the principle of equality in taxation has been the principle of ability to pay, which also has been incorporated explicitly in several constitutions. Currently this principle is reflected in the idea that the income tax should look at the consumption power of taxpayers.

The ability to pay is measured in terms of levels of income, wealth and consumption. Thus one basis for taxation, whether in the domestic or international sphere, is the faculty theory of taxation, or so-called “ability to pay” basis for taxation. In its simplest formulation, this is the idea that “every individual should contribute to the support of the public burdens according to his ability.” Domestically, the Netherlands has adopted the principle of ability to pay for a long time, especially with regards to the income and wage tax. After the reform of the Dutch Income Tax in 2001, the ability to pay principle finds it roots with more progressive rates and tax allowances. However, the

states that: ‘it should be noted that the (direct) benefit principle is used here merely as an underlying principle for allocating tax jurisdiction among states’.


Kemmeren, supra note 17, at 24.


treatments of capital gains, deductions and other features have eroded this application to various
degrees since the inception of the Dutch income tax. However the Court did not read the principle of
ability to pay as a general rule of taxation in the non-discrimination principle of Article 14 of the
ECHR.\textsuperscript{212} Van den Berge suggests that the reason for this decision was that the principle of ability to
pay can only be applied to individuals, while it is even then vague.\textsuperscript{213}

The faculty theory applies to international taxation as well. However this is considered to be vague
and controversial since the principle is (too much?) deeply rooted in the domestic tax system.\textsuperscript{214}
Thus only in a single-country situation this will work without constrains.\textsuperscript{215} However since it is not
limited to borders, it is always been connected with the principle of universality.\textsuperscript{216}

The League Report identifies the proposition that each taxpayer’s “whole faculty should be taxed
only once, and that the liability should be divided among the tax districts according to his relative
interests in each.”\textsuperscript{217} This articulates the proposition that double taxation should not properly occur,
but that taxing jurisdiction should occur according to these “relative interests”.

The League Report identifies “four principles on which the proceeds of taxation might be allotted to
competing authorities, namely” the following:\textsuperscript{218}

1. Political allegiance or nationality
2. Temporary residence
3. Domicile or permanent residence
4. Location of wealth

In international context this implies that each jurisdiction has the right to tax from services rendered
or benefits provided. In other words: each beneficiary of State expenses in services should pay their
fair share (\textit{i.e.} tax) for it (see chapter 6). With respect to the international context, Kemmeren \textit{e.g.}

\textsuperscript{212} HR 29 September 1999, BNB 1999/423.
\textsuperscript{213} Berge van den, J.W., \textit{Equality; Applying the Principle of Non-Discrimination (Article 14 ECHR, Article 26
ICCPR}, in: Gribnau, J.L.M. (ed.), \textit{Legal Protection against Discriminatory Tax Legislation}, The
\textsuperscript{214} Schö'n, W., \textit{International Tax Coordination for a Second-Best World} (Part I), World Tax Journal, October
2009, p. 70.
\textsuperscript{215} \textit{Ibid}.
\textsuperscript{216} Vogel, K., Part I., at pp. 217 et seq.
\textsuperscript{217} League Report at 101.
\textsuperscript{218} \textit{Ibid}.
states that the direct benefit principle is a part of the principle of ability to pay, which contains that the wealth of an individual provides him or her the capacity to pay taxes.  

2.2.3.2 Benefit Principle

The benefit principle is considered to be one of the traditional key principles of taxation. This is primarily based on the longstanding history of it, since it dates from the origins of the modern international tax regime and represents the key compromise that has propelled its success for many years. The current principle of benefit which is regarded to international tax regime could be dated to the issuance of a report published under the auspices of the League of Nations. In his nature, the benefit principle seeks at avoiding burdens on cross-border activity that are not proportional. The approach to achieve this is only to avoid double (or multiple taxation) by the jurisdictions that host, facilitate and generate cross-border investments. Some authors can derive from this fact that the benefit principle is a forerunner of the (relative newcomers) capital import and export neutralities. In contrast to these economic principles, the benefit principle is considered to be easily understood and widely embraced. In practice it allocates the jurisdiction to tax to the state that fosters the economic activity giving rise to tax. This right to tax could be derived from the services rendered by a state. In present sometimes reference is made to the benefit principle via the term 'economic allegiance'. It presupposes that by providing governmental services (e.g. infrastructure as well economic policies as low interest rates) give raise to levy taxes 'in the sense that the host country’s government bears some of the costs of providing the benefits that are necessary for earning the income.'

Kemmeren e.g., bases his preference for source over residence taxation on the traditional benefits theory. In this respect, this theory holds that this is justified by the fact that the source country

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219 Kemmeren, E.C.C.M., supra note 17, at 557.
221 See Nicholson, C.V., Chinese Carmaker Geely Completes Acquisition of Volvo from Ford, New York Times, Augustus 3, 20120, at B3. The principle of benefit is emerged from a world that bears little resemblance to one in which even the most readily identifiable of national business could change passports not once, but twice in little more than a decade (noting that Ford bought Volvo in 1999 and then sold it to a Chinese competitor in 2010).
226 Ibid, at 196.
provides the infrastructure and other publicly financed benefits to non-residents earning income in
the country. In the view of Bruins et al, the direct benefit principle is both part of the ‘faculty
principle’ as of the principle of ability to pay, since a person’s wealth provides him or her the ability
to pay taxes. Instead of the term ‘ability to pay’, the literature prefers the term ‘faculty’ as the first
might only refer to income taxes. The faculty principle implies horizontal (similar economic
situations – similar treatment) and vertical equality (different economic situations – different
treatment).

Avi-Yonah mentions for the purpose of defining the structure of the international tax regime two
(what he calls) ‘basic principles’, from which one of them was the benefit principle (the other was the
single-tax principle). In his view, the benefit principle implies (in international context) the taxation
of active business income primarily at source, and passive investment income at residence.

Conclusion

Bruins et al discussed the direct benefit principle as part of the faculty principle (or ability to pay): “So
far as the benefits connected with the acquisition of wealth increase individual faculty, they
constitute an element not to be neglected. The same is true of the benefits connected with the
consumption side of faculty, where there is room even for a consideration of the cost to the
government in providing a proper environment which renders the consumption of wealth possible or
agreeable [...]”. According to Kemmeren, the government may seize the elements of ability while
the wealth is created and levy income taxes. In contrast, Kaufman e.g., believes that the benefit
theory and the ability to pay theory are competing theories. However, Kemmeren points out that
Kaufman connects ability to pay with redistribution of goods in society.

De Wilde concludes that both the ability to pay principle as the benefit principle results from the
principle of equality, since e.g. two corporate taxpayers operating in different fields of business both
equally benefit from public goods provided (thus should equally contribute to the financing of it)

228 Professors Bruins, Einaudi, Seligman and Sir Josiah Stamp, Report on Double Taxation, submitted to the
229 Compare e.g. Ibid and Kemmeren, E.C.C.M., supra note 17, at 24.
230 See Avi-Yonah, R.S., Tax Competition, Tax Arbitrage and the International Tax Regime, Bulletin for
International Taxation 61, 2007, 130, p. 131
231 Ibid.
232 Professors Bruins, Einaudi, Seligman and Sir Josiah Stamp, Report on Double Taxation, submitted to the
233 Kemmeren, E.C.C.M., supra note 17, at 23.
234 Kaufman, N.H., Fairness and the Taxation of International Income, 29 Law and Policy in International
235 Kemmeren, E.C.C.M., supra note 17, at 23.
while in the case they realize a profit they should be liable to pay corporate tax to a certain amount (as they are able to pay).\textsuperscript{236}

\textsuperscript{236} Wilde, M.F., Some Thoughts on a Fair Allocation of Corporate Tax In a Globalizing Economy, Intertax, Volume 38, Issue 5, 2010, p. 287.
2.2.4 The principle of sovereignty

Already in 1952 Albrecht asserted that the state jurisdiction to tax ‘is justified in international law as an attribute of statehood or sovereignty, limited by international law and exercised in varying matters according to the policies of the states possessed of it’.\(^{237}\) However jurisdiction and sovereignty are not the synonymous.\(^{238}\) It is an aspect of sovereignty, coexistent with it and sometimes limited by it.\(^{239}\) Therefore it is clear that, in principle, fiscal jurisdiction can’t exist without sovereignty. International law functions as a norm that dictates jurisdiction to be an attribute of sovereignty, and based thereon a sovereign (i.e. state) may exercise jurisdiction.\(^{240}\)

It should be noted that international tax law is not an independent body of international law, but rather it “governs the taxing rights of sovereign nations.” Thus, a fundamental question in the exercise of international taxing authority is where the boundaries of fiscal jurisdiction of a sovereign nation-state may lie. “Fiscal jurisdiction” in this sense represents both the right of legislation and the right of enforcement. This is a problem for two reasons: 1) where a state does have fiscal jurisdiction, it may generally legislate (and impose taxes) to the exclusion of other nation-states; and 2) on the other hand, a nation-state may legislate even where it does not have fiscal jurisdiction, i.e., no right of enforcement.\(^{241}\)

All the above mentioned considerations create the interesting question whether full fiscal sovereignty exist, as expressed and defended by the EU Member States. The essence of a country’s sovereignty is to be free to meet its own political, economical and social development to shape.\(^{242}\) In the worldwide economic competition some countries should have huge tax revenues, while others can live with less. All these countries are in competition for global resources and with all means available including tax. Tax advantages were often used in the past to compensate non-fiscal disadvantages, which was recognized as a legitimate policy within the national territory of countries like the U.S. and Canada, and within the regional policy of the European Union.\(^{243}\) In this sense, the


\(^{240}\) Ibid.


\(^{242}\) Vanistendael, F., De fiscale Janus met het dubbele voorhoofd, soevereiniteit en schadelijke belasting concurrentie, TFO 2001/63.

\(^{243}\) Ibid.
Sovereignty is deemed to be a ‘concept of functional freedom’ for states, ‘through which they can alter and enhance the functions of their sovereign power and the level on which these functions are exercised’.

This implies inter alia any attempt to limit the state’s freedom of action is a violation of the principle of sovereignty.

As national systems of taxation interact more, sovereign nation-states may clash over the extent of their respective fiscal jurisdiction. Cooperation to resolve these issues of competing sovereignty, in turn, implicates further related issues:

1. Where sovereign states abrogate taxing authority to international bodies and systems, such abrogation may undermine the principles of democracy and representation. Taxpayers subject to such systems, as international law incorporated into national systems, may lack the usual mechanisms of representative government by which to hold such international systems accountable.

2. The legitimacy of laws may also be undermined by incorporation into national law of international law. As with the problems of democracy and representation, where domestic laws do not stem from constitutionally mandated sources, whence does their legitimacy arise? Without legitimacy grounded in the organic documents of governance, can the rule of law be said to apply?

Although the principle of sovereignty is not mentioned in the previous chapter, it certainly plays a general role in international context. International law acknowledges the sovereignty of states, which may be defined as the supreme authority over a territory and, also outside of their territory, over its citizens. This can be considered as the physical power of a state. Physical power can’t be the justification for the imposition of taxes and therefore the right of tax jurisdiction, as it lacks legal basis, i.e. it is not based on the law.

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245 Ibid.


247 Ibid., at 19. The author states that physical power might be necessary to enforce the right to tax.
Also the idea that taxation is based on a ‘social contract’ between the state and the taxable subject is for a long time rejected.²⁴⁸ Obviously, tax law has any principled foundation. In this principled foundation, the term ‘sovereignty’ is used in this context as it implies jurisdiction, i.e. tax jurisdiction, in other words: ‘the sovereign right of a state to levy tax for the purpose of financing the public goods provided’.²⁴⁹ The starting point of international tax principles is logically the legal basis, in other words, the right to impose taxes. It’s an attribute of statehood or sovereignty. ²⁵⁰ This is the principle of sovereignty. Without this power of the purse a state cannot function, since it enhances the collective well-being of its population via the redistribution of individual well-being.²⁵¹ As already mentioned in the first chapter, the concept of fiscal sovereignty is geographically restricted. On an international level, more supported by the globalizing economy, this entails that tax on corporate income involving cross-border operations cannot only been taxed national, hence it should be allocated between states: ‘sharing the tax pie’.²⁵²

Douma lists the three most important aspects of direct tax sovereignty (in the EU, direct taxation as a policy area remains part of the function sovereignty of a state²⁵³): first the freedom of a state to determine within its jurisdiction the policy concerning taxes; the obligation for a state to respect the direct tax sovereignty of other states and the fact that a state’s jurisdiction is limited by customary international law and bilateral tax treaties.²⁵⁴

The first aspect of sovereignty mentioned by Douma provides the correlation with aggressive tax planning, thus to be founded via the tax competition element. This is connected with the ‘privilege’ a state derives from the principle of sovereignty: to decide whether or not and to which extent it want to levy taxes.²⁵⁵ Thus this has led to tax competition with only few boundaries. This is considered to be a major driver for tax planning.

²⁵⁰ Kemmeren, supra note 17, at 18. The author refers to e.g. Otmar Buhler, Prinzipien des Internationalen Steuerrechts, Internationales Steuerdokumenteburo, Amsterdam 1964, p. 260.
²⁵² See supra note 15.
²⁵³ Douma, S.C.J., Non-discriminatory Tax Obstacles, EC Tax Review 2012-2, p. 69
²⁵⁴ Ibid.
²⁵⁵ Kessler, W. & Eike, R., Back to BASIC – Stages of International Tax Planning or: Getting the Grip on a Rocky Road, Intertax Volume 35, Issue 6/7, p. 373.
To conclude: in an international context sovereignty is one of the general principles. In this respect I feel strengthened by Douma, who also takes the point that ‘sovereignty must be regarded as a principle rather than a rule of international law’, since it is ‘not absolute but relative and the extent of which cannot be determined in isolation’.\textsuperscript{256} Conflicts between state’s sovereignty also never result in disapplying one of the sovereignties, but are always solved by giving precedence to one of them under particular circumstances.\textsuperscript{257} Like previously mentioned, this is exactly Alexy’s definition of a principle.

Douma also proposed the ‘four freedoms’ of the European Union as a principle, but they are considered to be out of the scope of this research, as they are too much bound to the European Union.

To conclude the geographically restricted principle of sovereignty entails in a globalized world that corporate income from cross-border activities should not only be allocated among taxpayers, but also between states.\textsuperscript{258}

\textsuperscript{257} Ibid.
\textsuperscript{258} Wilde de, M.F., Some Thoughts on a Fair Allocation of Corporate Tax In a Globalizing Economy, Intertax, Volume 38, Issue 5, 2010, p. 282.
2.2.5 Conclusion

Based on the principles mentioned in the previous sections, this figure summarizes the principles of taxation with respect to international tax law:

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Part of the figure is derived from Wilde de, M.F., *Some Thoughts on a Fair Allocation of Corporate Tax In a Globalizing Economy*, Intertax, Volume 38, Issue 5, 2010

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The figure is divided into two parts: on the one hand the ‘formal’ side and the ‘material’ side on the other hand. Both parts are derived from the principle of justice, which is previously determined as the most fundamental principle of taxation. Tax systems should be fair (justice is in the context of tax often used in the term ‘fairness’), via the principle of equality fairness should be achieved. Following Lang, the principle of justice is split into a formal and material part.\textsuperscript{260}

The founding principle of the formal part is (as with the material part) the principle of equality, which is determined to be an element of the principle of justice.\textsuperscript{261} Vanistendael e.g. underlines the procedural meaning of the principle of equality.\textsuperscript{262} General laws must be applied equally (and impersonally) to all, which serves the rule of law. The fundamental legal framework, which is in my view a synonym for the ‘material part’, should be in accordance with the rule of law.\textsuperscript{263} The rule of law aims at protection against arbitrary interferences.\textsuperscript{264} This is connected with the principle of representative democracy, which said in other words: ‘no taxation without representation’.\textsuperscript{265} Therefore every principle of the ‘formal part’ is connected, directly or indirectly, with the principle of the rule of law. The principle of equality is historically connected with the principles of democratic legitimacy and the rule of law.\textsuperscript{266} Therefore these three principles are considered to be the key-stone principles of the ‘formal part’.\textsuperscript{267} Since t democracy and the rule of law must be in balance, they are used as the starting-, respectively, the endpoint of this ‘formal part’.\textsuperscript{268} Since the principles of the ‘formal part’ are more of a ‘legal theory discussion’ they are considered to be not suitable for this research and will only be mentioned short under the section 6.7 (‘institutional issues’).

The material part starts is derived from the material part of the principle of justice, in practice achieved by the principle of equality.\textsuperscript{269} In my opinion, equity and neutrality are interchangeable as they both ensue from the same underlying notion: equality. This already has been clarified by Kemmeren, who defended that worldwide economic efficiency is maximised by allocating production

\textsuperscript{266}Magna Carta, 1215, also Petition of Rights, 1628.
\textsuperscript{266}Ibid, at 2.
\textsuperscript{266}Tipke, K. and Lang, J. \textit{Steuerrecht, ein systematischer grundsatz}, Cologne: Otto Schmidt Verlag, 1991
factors where they earn the highest income or return (in order to increase worldwide prosperity). However, he adds that apart from this efficient creation of income, worldwide prosperity also depends upon an equitable distribution of income. In practice the principle of equity may be based either on the benefit principle or the ability to pay principle, while in practice it is commonly based on the latter (particularly on individuals). Thus, as is clarified in the previous paragraph, the ability to pay and benefit principle is directly linked to each of the previous principles as they are (in this respect) underlying principles for allocating tax jurisdiction.

The principle of sovereignty was not divided into the ‘level-based’ approach. Therefore this principle will not be further investigated in detail in this research, although it is an important principle. It certainly plays a huge role in the discussion concerning international tax jurisdiction, but it is of a ‘different’ nature than the other (level-based) principles. The principle of administrative convenience has a practical nature; therefore it is not included in the relevant principles scheme. This function is different from the role of equity and efficiency, as it does not reflect to the normative question how tax should be allocated among taxpayers and between states.

### 2.3 The relevant principles of taxation for this research

To conclude the geographically restricted principle of sovereignty entails in a globalized world that corporate income from cross-border activities should not only be allocated among taxpayers, but also between states. This allocation methodology currently applied seeks to capture the economic presence and to localize geographically the value added in order to place it within the territory of state that may subsequently tax it. In the field of direct taxation this is primarily done via the allocation principles of residence and source. In contrast, the indirect taxation method makes primarily use of the principles of origin and destination. In contrast, the indirect taxation method makes use of the more quantitative allocation principles of universality and territoriality. These qualitative allocation principles are based on the more quantitative allocation principles of universality and territoriality. These will be discussed in chapter 3 (indirect) and chapter 4 (direct). Since the qualitative principles derive from the quantitative principles, the latter principles will be put into ‘level four’, while the qualitative principles will be put into ‘level five’. It should be noted that the principle of neutrality connects the field of direct taxation with the field of indirect taxation.

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Based on the information from the previous paragraphs, one can conclude that the basic concept of international taxation is out of date. This goes hand in hand with the current globalization, which is simply caused by this fact. This figure will be used as a benchmark for the assessment of the principles of the next level: the allocation principles: principles of residence, nationality, source, origin.\footnote{As summarized by Kemmeren, E.C.C.M., supra note 17, at 18.} Since the above mentioned principles are (or should be) the same for each country, it is quite difficult to make a relevant comparison of each above mentioned principle. Although this might not be impossible, this is not the aim of this research. The allocation principle \(i.e.\) residence, nationality, source and origin) are of a more practical nature. They are the practical underlying principle of the allocation rights between states in direct taxation. For the indirect part, the destination principle will be investigated.

In the upcoming chapters, the role of the general principles will still be mentioned for the sake of the ‘full picture’. However they will not be used as the primer benchmark for the allocation principles, since this is not the aim of the research (also this will be more of a PhD project).

This research will therefore focus primarily on the relevant allocation principles, although also other principles will be mentioned since allocation principles are always connected with previous levels of principles. This will be done in both indirect (chapter 3) and direct taxation (chapter 4). The observations made from the EUCOTAX Wintercourse week in Lodz will be pointed out in chapter 6. All of these principles will be tested against their sensitivity for aggressive tax planning in chapter 7.
3. Principles in indirect taxation

3.1 General overview

In this chapter, the underlying principles of indirect taxation are examined. As is stated in the introduction, the direct taxes might learn from their ‘sister’ the indirect taxes. This chapter is dedicated to the discussion of the legally relevant and possibly different characteristics of indirect taxes, in the broader context of an analysis of tax principles. The fact that both ways of taxation vary dramatically could be illustrated by a simple example about the purpose of taxation: the traditional purpose of taxation is to raise revenue to meet government expenditure.

This will, at first sight, led that one can argue that there is no difference on the purpose between direct taxes and VAT. However, even in this respect there’s a difference within the European Union: while direct taxes purely raise revenue to meet government’s expenditure, part of the revenue of VAT on the other hand is raised for funding expenditures of the European Union.

Besides this classic function, taxation has also sometimes the format of an instrument. To say it gently: not all tax academics are convinced that taxes should be used in an instrumental way. The fact that the function of taxation can be divided into two parts is also defended by some authors, who call these two types of taxation are respectively used for ‘internal’ and ‘external’ policy goals.

VAT can be regarded as a consumption tax, borne ultimately by consumers; it has a complementary function on the income tax.

276 Note on European Communities terminology: this research adhered to ‘official’ terminology as used in the English versions of EU legislation. In some cases, however, this may result in confusion for readers unfamiliar with EU language usage. The following two terms pose particular difficulties: ‘legal person’ is to be construed in the sense of an incorporated body entity or association, as distinct from an unincorporated entity or individual; the term ‘exempt’ is used in Community legislation to include the UK concept of ‘zero-rated’. In the continental systems, the distinction made in the UK between ‘exempt’ and ‘zero-rated’ is expressed as ‘exempt without credit’ or ‘exempt with an entitlement to recover input tax’.

277 This was introduced by the Council decision of 21 April 1970 (EEC, ECSC, Euratom) 70/243 (OJ L94 28.4.70 p. 19 S 1970 (I) p. 224) based on which the budget of the European Communities had to be wholly financed by its own resources.


Direct taxes are taxes on income. Examples are the Personal Income Tax, Corporate Income Tax and Dividend Tax. Indirect taxes are taxes on consumption. Examples of indirect taxes are the VAT, Excise Taxes, taxes on cars, Environment taxes and the currently discussed Bank Levy.

In this framework, it must be clarified what kind of direct tax should be contrasted with a standard VAT/GST. The scope in the category of indirect taxes of this chapter will be, as it is predominant in the European Union, on VAT instead of GST. Hence, in the present chapter the VAT will be discussed. The characterization of as a direct or indirect tax merely relies on different techniques of taxation envisaged by the legislator: direct taxes are characterized by the presumed coincidence of the taxable person or tax subject, on the one hand, and the person effectively paying the tax or the final taxpayer on the other hand.

In contrast, an indirect tax is supposed to be shifted from the taxable person to a different person in the price of goods supplied or services rendered by the former to the latter, who thereby becomes the final taxpayer.\(^\text{282}\) Since there is no guarantee that indirect taxes will always be shifted, nor that direct taxes will always be borne by the taxpayer, this distinction rests preliminary on the conception of the legislator and the ensuing legal features of the tax.\(^\text{283}\)

Recent developments and trends show that there is worldwide shift from direct to indirect taxation. For example, in The Netherlands, the (former) government also marked this as one of the key discussion point for next year’s tax policy.\(^\text{284}\) This underlying idea about this is more specific to shift the balance from taxes on work to taxes on consumption.\(^\text{285}\) Reducing the tariff on taxes on work will be made possible via an increased tariff on consumption taxes. Increased revenues as a result of the higher tariff on consumption taxes could reduce the amount of taxes. This shift from direct to indirect taxation will be further elaborated in paragraph 3.6.

It should be noticed that the indirect taxes rather than direct taxes already representing a bigger amount in terms of revenues to the state.\(^\text{286}\) The revenues from direct taxes to the state amounted in 2011 €68.9 milliard, while the indirect taxes collected approximately €71.3 milliard on the other

\(^{284}\) Dutch department of Finance, *De Fiscale Agenda* (2011) p.2.
\(^{285}\) Ibid.
\(^{286}\) Dutch Household Account 2011, presented on the opening-day of the Dutch Parliament, see: http://www.prinsjesdag2011.nl/miljoenennota/huishoudboekje_van_nederland/downloaden
hand.\textsuperscript{287} In the number of indirect taxes, VAT represented the biggest amount, worthy about €42.3 milliard.\textsuperscript{288} For this reason, this chapter will discuss exclusively VAT and not the other indirect taxes.

3.2 Introduction to VAT

3.2.1 Statutory basis

The statutory basis for a State’s tax has to be a formal law. Pursuant to Art. 104 of the Dutch Constitution taxes cannot be imposed the force of the law. On 28 June 1968 the Netherlands adopted a VAT type of turnover tax to replace, as of 1 January 1969, the old cumulative turnover tax. The Dutch refer to the VAT as \textit{Belasting over de Toegevoegde Waarde}, abbreviated BTW, which find its statutory basis in The Value Added Tax Act 1968.\textsuperscript{289}

Based on Art. 94 of the TFEU indirect taxes have to be harmonized, in order to realize an internal market between Member States. The definition of an internal market is: ‘the elimination of all obstacles to intra-community trade in order to merge the national markets into a single market bringing about conditions as close as possible of a genuine internal market’. The elimination of obstacles within the community in order to stimulate the free movement of goods and services, started with the abolition of customs duties and the harmonization of VAT.

The statutory basis for the European VAT is the VAT Directive. European VAT has been laid down in many Council Directives: the First, the Second, the Sixth, the Eighth, the Thirteenth Directive etc. At the heart of Community VAT legislation was the Sixth Directive, which has been in force for thirty years; it dates from 1977. This Directive and its many amending acts have been replaced by Council Directive 2006/112/EC of 28 November 2006. The objective of the new Directive is to recast all text without changing existing legislation. As a result of the recast various provisions were put together in a single piece of legislation.

The value added tax system – the leading system for all turnover taxes nowadays – has been introduced in all Member States. National tax laws have already been harmonized to a large extent. However, it should be noted that the exact wording of VAT Directive 2006/112/EC has not been incorporated into the Dutch legislation and there are many derogations which must be taken into account.

\textsuperscript{287} \textit{Ibid.}
\textsuperscript{288} \textit{Ibid.}
VAT covers the entrepreneurs’ economic activities, affects retail prices and is a huge ‘revenue raiser’ in Member States and for Brussels, as its income depends on value added tax (a small percentage of the national bases of VAT transmitted to the EC).

3.2.2 Legal basis

The statutory basis forms the existence of VAT. The legal basis however, is the justification of a tax. The preamble of the VAT Directive (and the First, Second and Sixth Directive) lacks such a legal basis. Van Norden concludes in this PhD-thesis that the legal basis of VAT cannot be determined. In this opinion he shared the view on the legal basis of Smeets, which according to him may be missing: ‘Our system of taxation has grown historically, therefore no general line exists as therefore may be many reasons put forward’.

For example, Braun points out that the Netherlands historically a link exist between on the one hand the wage and income tax, and the VAT on the other hand. In 1934 the Netherlands introduced a VAT to supplement the income tax, because a further increase of the latter was not possible. Although in the literature different opinions exist whether the VAT is a tax according to the ability to pay. Not in particular on the question whether the legal basis is ability to pay, thus VAT has elements of this principle. The most important elements of these is the tariff differentiation. Stevens believes that from this fact the VAT can scrutiny the character of a tax in accordance with the principle of ability to pay.

Although the consensus, which I concur, is that the ability to pay principle cannot function as the legal basis of the VAT: ‘VAT, like most taxes on goods and services, had little to do with ability to pay.’ Braun justifies the application of VAT in combination with the wage- and income tax on the basis of the principle of ability to pay with several arguments. In this respect this research is so free to use the complete summary of van Norden.

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In his view there are several arguments which plea for the use of VAT, from which the first is that determining the turnover is easier than determining income.

Who avoids the levy of the income tax, will not do the same for VAT by suppliers and service providers who shift the claim. The second reason is that the levy of VAT is generally less sensitive for resistance than the income tax; it is also less cyclical than the income tax. Besides this, the income tax relates only the income earned in a particular period and does not take into account how much effort this income required. An above-average long period of work can increase the income which therefore enhances the progressivity. A VAT which is more or less proportional can reduce this effect.

Next to this, the regulation and implementation of VAT is simpler than of the income tax. A last reason is that if the amount of revenue raised by the VAT should be compensated by the income tax, as a result the tariffs of the income tax would rise to unacceptable levels.

3.2.3 Legal nature

In the literature much attention is paid to the question of the legal nature of the VAT, more than in the case of direct taxes. One explanation could be found in the fact that direct taxes in general from the law itself show who and what is taxed. In VAT, the situation differs, because the tax burden is up to the consumer but the tax is paid to the Treasury by the businessman in claim (this implies the ‘indirect’ effect of the tax). The one who bears the tax is another person than the one who pays it actually on a tax return. The latter is called ‘taxable person’ although he does not bear the tax. In this respect the question will arise what exactly can be defined with the term ‘legal nature’, as there is a lack of consensus.

For this reason, van Kesteren cites two extremes of the scale on which the concept of legal nature can be defined. According to his opinion, the first extreme is that the legal status is a general - already in the subject of law is formulated - ideal in principle in every facet of the law is (or should be) translated, it is a guide that indicates who and what should be taxed. Therefore the law as finally appears in the State courant, is a more or less successful development of this standard. Since it is both in the construction of the statutory provisions as in its normative interpretation.

The opposite reasoning, i.e. the other ‘extreme’, according to van Kesteren is that the legal status is a

total picture of all the special features of an existing law. Consideration is whom the taxpayer is and what is taxed. The resulting overall picture is standard set in the interpretation or in the construction of the law.

It is common sense in the literature that the term ‘legal nature’ refers to the sought to answer the question who and what the legislator want to tax.\textsuperscript{302} As this research is not the place to discuss the term ‘legal nature’ itself in detail, together with van Norden this research considers the description of Van Hilten and Van Kesteren as the most striking.\textsuperscript{303} They define the legal nature of the VAT as follows: ‘a consumption tax designed to charge and does by spending as a benchmark to’. The object of taxation is the consumption needs. Under the "consumption" in economic terms can be understood as the direct and final use of goods and services to satisfy needs of individuals.\textsuperscript{304}

The VAT is based on the object-consumption, in the regulations reflected in supplies and services - and the tax can be levied, there is a person sought.\textsuperscript{305} The VAT is described in art.1 (1) VAT Directive as a general consumption tax on goods and services. Striking here is that the European Commission in first instance tried to hide the legal nature of the VAT.\textsuperscript{306}

3.2.4 Characteristics of VAT

VAT is harmonized and thus in the vision of the EU leading and dominant towards the national point of view. Indeed, national law must be executed in accordance with European law. The characteristics of the VAT system are therefore the ones which the Court has pointed into the law.\textsuperscript{307} The ECJ has indicated four essential characteristics of VAT: the tax applies generally to transactions related to goods and services; it is proportional to the price charged for the goods and services; it is charged at each stage of the production and distribution process and the taxable person (vendor) may deduct the tax paid during the preceding stages, that is the burden of the tax is on the final consumer.\textsuperscript{308}

\textsuperscript{303} Norden van, G.J., \textit{Het concern in de btw} (diss.), Kluwer, Deventer, 2007, p. 27.
\textsuperscript{307} This is also supported by the doctrine, compare e.g.: Schenk, A., and Oldman, O., \textit{Value Added -Tax, A Comparative Approach}, Cambridge University Press, New York, 2007, pp. 16-17 and pp. 33-34. See also Paardt van der, R.N.G., \textit{Subsidies in de Europese Unie} (diss.), Kluwer, Deventer, 2000, p. 59.
\textsuperscript{308} See e.g.: ECJ 27 November 1985, Case 295/84, SA Rousseau Wilmot v Caisse de compensation de L'organisation autonome national de l'industrie et du commerce (Organic), [1985], ECR 03759, at para. 15.
3.2.5 Conclusion

The sections 3.1 and 3.2 gave a short introduction on the key characters of the VAT system. The upcoming sections will discuss the relevant principles (which have been developed in chapter 2) with respect to VAT. The justification of this benchmark of principles has already been set out in chapter 2. Applying these principles to VAT is also justified by the fact that these principles also find their basis in the Ottowa Taxation Framework. Although they were designed in the context of the theme of the Congress (i.e. e-commerce), the OECD recently considered these principles as ‘remained valid’ for the more global interaction of consumption tax systems, since they ‘broadly reflect the philosophy of the existing rules in most countries’. These principles are: neutrality, efficiency, certainty and simplicity, effectiveness and fairness, and flexibility. Indeed, merely the same principles as developed in the framework of chapter 2. In this comparison the ‘first level’, i.e. general legal principles, will not be discussed any further as this is considered to be a very difficult field to discuss and beyond the scope of this research.

3.3 Basic principles of VAT

The VAT framework has been introduced in the paragraphs 3.1 and 3.2. After this framework it is time to take a closer look on the principles underlying the VAT system.

The underlying principles of the VAT system are in essence to be found in the preamble to the VAT Directive and are confirmed in ECJ case law. Principles that can also be considered as underlying the VAT system, such as the principle of the prohibition of abuse of rights and the principle of legal certainty, are left aside. As a result, the essential principles of the overall design of the VAT system are considered to be:

1. VAT is a general, objective tax (general, objective character);

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309 The Ottowa Taxation Framework conditions were welcomed by Ministers from 29 Member Countries and 11 non-member economies at the Ministerial Conference on Electronic Commerce held in Ottawa on 7-9 October 1998.

310 OECD, International VAT/GST Guidelines on Neutrality, approved by the Committee on Fiscal Affairs on 28 June 2011, p. 4.

311 Ibid.


2. VAT is levied in a neutral manner (tax neutrality);\textsuperscript{315}
3. VAT is a tax on consumption (intended to tax consumer consumption);\textsuperscript{316}
4. VAT is exactly proportional to the price of the goods or services.\textsuperscript{317}

According to the OECD these features give VAT one of its main characteristics: \textit{i.e.} neutrality.\textsuperscript{318} They will be discussed later in this section. Also, attention should be paid to the principle of expediency. This principle functions as a correction to the three above mentioned starting points of VAT, in cases where the application of the law would be stranded on impracticability.\textsuperscript{319}

\textbf{Equity}

As described in section 3.2.5., the ‘first level’ of general legal principles will not be discussed in this chapter. Therefore the comparison will start with the ‘second level’, \textit{i.e.} interchangeable principles of international taxation thus more specific the principles of equity and efficiency. With respect to equity, this principle could be split into two parts: horizontal and vertical equity.\textsuperscript{320} Horizontal equity is attained by VAT, since all goods and services are to be treated equally.\textsuperscript{321}

On the other hand, VAT does not seem to be suited to promote vertical equity.\textsuperscript{322} The typical example of vertical equity could be the exempting low income from income tax. Under the VAT system, the mere consumption is taxed. Some argue that this lead to double taxation of higher income (they pay income tax plus VAT), and on the other hand taxation of the poor. To prevent the latter, some countries introduced the zero rates in VAT. However, the statement that the poor

\textsuperscript{315} See, for example: ECJ 22 May 2008, Case C-162/07, Ampliscientifica Srl and Amplifin SpA v Ministero dell’Economia e delle Finanze and Agenzia delle Entrate, [2008] ECR I-04019. The principle of neutrality is considered as the reflection in the field of VAT of the general principle of equal treatment. See, for example: ECJ 10 July 2008, Case C-484/06, Fiscale eenheid Koninklijke Ahold NV v Staatssecretaris van Financiën, [2008] ECR I-05097.
\textsuperscript{316} See Art. 2(1) VAT Directive
\textsuperscript{317} The price proportionality principle not only entails that double non-taxation is prohibited but also that cascading of VAT in the production and distribution chain is not allowed. See, for example: ECJ 25 May 1993, Case C-193/91, Finanzamt München III v Gerhard Mohsche, [1993] ECR I-02615, ECJ 8 November 2001, Case C-338/98, Commission of the European Communities v Kingdom of the Netherlands, [2001] ECR I-08265 and ECJ 10 July 2008, Case C-484/06, Fiscale eenheid Koninklijke Ahold NV v Staatssecretaris van Financiën, [2008] ECR I-05097.
\textsuperscript{318} OECD, \textit{International VAT/GST Guidelines on Neutrality}, approved by the Committee on Fiscal Affairs on 28 June 2011, p. 3.
\textsuperscript{320} Compare chapter two, especially section 2.2.1.
incomes would benefit from this zero rate is not underlined in several surveys, which have shown that middle- and high-income groups benefit more in an absolute amount of zero rates than the poor.\textsuperscript{323} The recommendations of these surveys point out that the poor are better served by transfer payments by governments or by providing better social security through VAT but not by zero rating several types of goods and services.

**Tax efficiency**

In the field of VAT, tax efficiency is described in the context of the OECD report as ‘compliance costs for businesses and administrative costs for the tax authorities should be minimized as far as possible’.\textsuperscript{324} In contrast to this, tax neutrality is described (in the same report) as ‘taxation should seek to be neutral and equitable between forms of commerce. Business decisions should be motivated by economic rather than tax considerations. Business in similar situations carrying out similar transactions should be subject to similar levels of taxation’.\textsuperscript{325} Tax neutrality (see Chapter 2) is the binding connecting factor between direct and indirect taxation. It is the bridge that connects the two sides of the medal of taxation. It could also be described as the heart of the VAT system.\textsuperscript{326} The OECD mentions the full right of deduction on the input tax through the supply chain (except the final consumer) as the key-concept of neutrality.\textsuperscript{327} This right is ensured, whatever the nature of the product, structure of the distribution chain and the technical means of delivery. Thus it doesn’t matter whether this is done via internet, retail stores or physical delivery. Another aspect mentioned by the OECD is that VAT should also be neutral in the sense that it should not discriminate between similar businesses and these businesses should not bear compliance costs which could distort their economic decisions.\textsuperscript{328}

The principle of neutrality in VAT contains numbers of dimensions.

**Tax neutrality**

The concept of ‘tax neutrality’ is (surprisingly) not defined in the VAT-Directive. However, the preamble seeks to promote the greatest degree of ‘neutrality’. According to the ECJ, the principle of


\textsuperscript{324} OECD, International VAT/GST Guidelines on Neutrality, approved by the Committee on Fiscal Affairs on 28 June 2011, p. 4.

\textsuperscript{325} Ibid.

\textsuperscript{326} OECD, International VAT/GST Guidelines on Neutrality, approved by the Committee on Fiscal Affairs on 28 June 2011, p. 3.

\textsuperscript{327} Ibid.

\textsuperscript{328} Ibid, at 4.
neutrality is a fundamental principle of VAT. Extracted from the principle of equality (or justice as being the ‘highest principle’), neutrality is a special appearance of this main principle. According to the EC, the general principle of equality basically functions as a ‘catch-all clause’. In addition there is also an economic dimension to identify, where the neutrality implies that the tax is strictly proportional to the price.

Hence this fundamental principle has several dimensions. Basically it could be divided into internal and external neutrality. Internal neutrality is connected with the internal market, whereas external neutrality relates to the international aspects. This external neutrality is guaranteed only in the case when the tax levied on import does not exceed the amount of the tax which is levied on domestic goods of the same kind. In this respect, the amount of the refunded tax (in the case of exports) has to be equal to the amount of tax levied. Internal neutrality guarantees (in the case of exports) that they are exempt from the tax while the tax on imports is levied in the amount that is equal to the amount of the tax levied on non-imported, i.e. domestic, products. This internal neutrality can be further elaborated into legal, competitive and economic neutrality.

**Legal neutrality**

The principle of equality guarantees equal treatment. As mentioned, the neutrality principle is a special appearance of the principle of equality. The function of this legal aspect is effectuating the neutrality of competition. Equal treatment in VAT is mentioned as first in the preamble of the VAT-Directive:

“The common system of VAT should, even if rates and exemptions are not fully harmonised, result in neutrality in competition, such that within the territory of each Member State similar goods and services bear the same tax burden, whatever the length of the production and distribution chain.”

Legal neutrality is connected when the tax is measurable: when there is a relation between tax burden and the ratio of the consumption of the taxpayer. In this respect VAT has to be set as a percentage of the sales price (the tax burden has to be proportional). However under the

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331 ECJ 10 april 2008, nr. C-309/06 (Marks & Spencer III), V-N 2008, 211.22, r.o. 49.
333 Punt 7 van de considerans van de Btw-richtlijn. In de Eerste (punt 8), Tweede (punt 3) en de Zesde (punt 4) Richtlijn waren ook vergelijkbare overwegingen opgenomen.
current cumulative system of turnover tax, which is applied within the EU since 1960, this legal neutrality could not ever have been reached, since the amount of the tax could have been reduced by both vertical or horizontal integration. On the other hand identifying the tax burden is quite difficult since for the identical good could have been produced by producers with a different level of integration which implies that the tax burden differs.

In situation when the tax rate is set as a percentage of the sales price, enterprises do not have any reason for ‘integration for tax purposes’ and therefore competition is not distorted. This system is known as competitive neutrality: competition is not distorted. However, the integration may influence the amount of the tax which could result in the fact that also this neutrality could not been achieved.

**Economic neutrality**

In economic sense, neutrality holds that the levying of taxes distorts the optimal distribution of wealth as little as possible. However complete neutrality is a utopia, taxes without doubt do affect economic decisions. Hence the economic neutrality can be assessed only in certain designed ratios.\(^{334}\)

**Competitive neutrality**

When the tax burden is not dependent on the rate of vertical or horizontal integration, competitive neutrality is guaranteed.\(^{335}\) Companies do not have any reasons for ‘integration for taxation purposes’ in situations when the tax rate is set as a percentage of the sales price, hence competition will not be distorted.\(^{336}\)

**Ability to pay principle**

There’s tremendous discussion whether the principle of ability to pay applies to VAT.\(^{337}\) Defenders of this theory argue that this principle the starting point is for fairness to consumers in VAT and influence the design of the VAT system, while others disagree and state that consumption taxes should not be analysed in the light of the ability to pay principle.\(^{338}\) Lang et al believe that although a

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\(^{334}\) J. Reugebrink, Enkele beschouwen over de neutraliteit van de omzetbelasting (oratie), Kluwer, Deventer, 1965, p.4.


\(^{336}\) However under the cumulative cascade system of turnover tax, integration for tax purposes may influence the amount of the tax and therefore complete neutrality cannot be guaranteed.

\(^{337}\) Compare *e.g.* Conference: Value Added Tax and Direct Taxation – Similarities and differences, Vienna University, 26-28 March 2009.

huge amount of scholars ‘have endorsed the idea that VAT is a charge that seeks to distribute the tax burden according to the ability to pay, many of them will still accept income as the only adequate reference point for the specification of the ability to pay principle’. 339

However van Doesum e.g. states that even though the VAT is not a levy on the ability to pay, it is indeed a charge of the carrying capacity. 340 The principle of ability to pay ultimately ensures that each individual after taxation has sufficient rests to provide the necessary sustenance (the principle of necessary sustenance or the principle of the ‘ability to pay’). 341 It provides both for equality as for proportionality. 342 This is an expression of solidarity between citizens. 343 However this does not imply that the VAT, separately, in his nature is a levy based on the principle of ability to pay. 344 Apart from any ‘alien’ aspects in the VAT (e.g. reduced rates, exemptions, and special schemes) the VAT does not aim at redistribution of income. The principle of ability to pay has an economic dimension in the world of VAT. The VAT takes the principle of ability to pay into account in the sense that it takes into account the spending power (or: ability to pay) of citizens. This fits well to the idea to take consumption as a measure of the ability to pay.

**Benefit principle**

At present there is a broad consensus at least in democratic societies that a VAT should refrain as far as technically possible from taxing expenditure for the basic necessities of life. 345 Primarily due to the fact that this is very difficult to apply on business- to business transactions (it cannot account for input tax credit). Furthermore this side of the income is reserved for the income tax, according to the ability to pay principle.

To conclude It does not seem convincing to establish an ethically purpose of VAT on the benefit principle. 346

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339 Lang, M. and Melz, P., Value Added Tax and Direct Taxation, Similarities and Differences, IBFD, Amsterdam, 2009, p.28
3.4 Quantitative legal principles in VAT

Allocation of taxing rights in direct taxation is, as already shown, done through international tax rules. In practice all countries either use a worldwide or a territorial principle, or a combination of both. In VAT allocation of taxing rights is usually done through the establishment of what are known as ‘place of supply rules’. These rules are established into the VAT since the Second Directive. These various rules functions as proxies for one basic rule of allocation: taxation should take place at the place where goods or services are consumed. As already mentioned, VAT is a tax on goods and services. The first category the allocation is achieved through rules primarily based on the destination principle. This principle operates since 1992 within Europe through an intra-Community transaction regime known as the transitional VAT system.

3.4.1 Principle of universality

The nature principle of universality could be seen as a key element of VAT. Art. 1 of the VAT-Directive provides that ‘on each transaction, VAT, calculated on the price of goods or services at the rate applicable to such goods or services, shall be chargeable after deduction of the amount of VAT borne directly by the various cost components’. The universality of imposing VAT is manifesting both at national level (every transaction is taxed independently of the person who carries it out – as long as that transaction is effected in the context of an economic activity in the sense of the VAT-Directive) and at the material level (each supply of goods is, in principle, taxed). Universality in the meaning of worldwide tax systems holds a different story, as this is not present.

In the conference ‘Value Added Tax and Direct Taxation – Similarities and differences’ at the University of Vienna was argued that worldwide taxation is unsuitable for VAT purposes, as it is impossible to tax resident consumers if they, for example, consume abroad.

3.4.2 Principle of territoriality

In general VAT follows the principle of territoriality; since only supplies that take place within the territory of the country can be taxed by this country. The principle of territoriality is supplemented by the destination principle, in contrast to the origin principle, which aligns the taxing right to the state of origin. Thus the state of destination is the state where the recipient is established or the

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Art. II (2) of the GATT underlines that cross-border trade is ruled by the destination principle. In relation to VAT, the destination principle is fulfilled by exempting the export of goods from VAAT and refunding levied tax. On the other hand VAT is imposed on imports, which ensures taxation in the place of consumption. However it should be noted that VAT is totally different than direct taxation. It is an impersonal tax, whereby the key element of a taxable event is the event (transaction) itself and not the person who carried out the taxable supply. Therefore the connection of the taxable product to the taxable person is not of importance and serves merely as an act to facilitate tax collection. Thus VAT follows objective connecting factors such as origin or consumption, rather than personal factors.

### 3.5 Qualitative legal principles in VAT

These part focuses on the principles underlying the jurisdiction to impose VAT. Schindel and Atchabahian state that ‘jurisdictional connection is defined as the criteria connecting the material element of the taxable event with the scope of a state’s taxing power’. In direct taxation the principles underlying the jurisdiction to impose taxes (i.e. the relevant principles of this research) in direct taxation are the source and residence principle. Under VAT these principle are the origin and destination principle.

In this respect, the origin principle is logically analogous to source-country taxation. The destination principle appears at least at first sight, to be logically analogous to residence-country taxation. Several scholars draw this comparison between source and residence principle, on the one hand, and the origin and destination principle, on the other. Despite the frequency of this comparison, it seems to be of little significance for three reasons. Millar lists the fact that ‘the origin principle is not a significant contender’ as first, since it is *communis opinio* that the destination principle should be used.

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353 Compare section 2.3. of this research.
A second reason why the analogy is of little relevance is because the origin taxation of supplies is equivalent to resident taxation of supplier’s income.\textsuperscript{357} From the point of view of the tax payer, the origin principle is in fact analogous to residence rather than source. On international levels, the taxation of consumption on a source basis (\textit{i.e.} at origin) is equivalent to taxing the income of suppliers on a residence basis. In contrast, in the view of the supplier the principle of origin is more akin to residence taxation of income. This is another argument against origin-based taxation of consumption. If the arguments in favour of source country taxation of income on the basis of international equity ‘have any merit, then they must be equally applicable to consumption tax; and since taxing consumption is equivalent to taxing the income of suppliers on a residence basis, the international equity arguments should presumably favour taxing consumption on a destination basis’.\textsuperscript{358}

The last reason is that residence of consumer is not equivalent to destination. For the purposes of VAT, destination means \textit{place of consumption} and thus not \textit{residence} of the consumer. The fact that the practical effect of the destination principle often results in taxation of consumption where the consumer is resident, is due to the fact that consumers often consume goods in their country of residence. This has nothing to do with the fact that VAT sues customer residence as the basis for asserting substantive jurisdiction.

\textbf{3.5.1 Principle of Residence}

The role of the principle of residence in VAT is less significant than the role this principle fulfils in direct taxes. Consumer residence is used as one of the proxies for predicting the place of consumption of many services, but mostly this is due to an underlying presumption that consumption of the relevant type of supply will take place where the customer is resident.

\textbf{3.5.2 Principle of Source}

VAT is based on the destination principle therefore the source principle is not precluded.\textsuperscript{359}

\textbf{3.5.3 Principle of Destination}

The destination principle allows the VAT to keep the tax neutral in cross-border trade. According to this principle, exports are exempt with refund of input taxes (\textit{free of VAT}\textsuperscript{360}) and imports are taxed

\textsuperscript{357} Ibid.

\textsuperscript{358} Ibid., at 284.


\textsuperscript{360} ‘\textit{Free of VAT}’ may be termed zero-rated, exempt with credit, or some local terminology. Whatever the description used, the effect should be the same. No VAT is added by the supplier but the supplier is entitled to input tax credits, to the extent that the jurisdiction allows, in respect of such supplies.
on the same basis and with the same rates as local supplies or local production. This mechanism implies that the amount of total tax paid in relation to the supply is determined by the rules applicable in the jurisdiction of the consumption and therefore all revenues accrue to the jurisdiction where the supply to the final customers occurs. This destination principle is sanctioned by the rules of the World Trade Organization.\footnote{Compare the ‘Agreement on Subsidies and Countervailing Measures’, footnote 1.}

The destination principle finds its way in the derogation of the general rule of Art. 32 VAT-Directive, which stated that if goods are dispatched or transported, the place of supply of these goods is where the transport starts. By way of derogation, this place is changed (if certain conditions are fulfilled) to the place where the goods are when the dispatch or transport to the purchaser ends, an example of the application of the destination principle.\footnote{Conditions are quite equal as those described in \textit{supra} note 46. As these conditions are not relevant for this research, they will not be further described here.}

The destination principle is considered to be very suitable for the international trade in tangible goods, since it can be underpinned by frontier or border controls.\footnote{Compare OECD, \textit{International VAT/GST Guidelines on Neutrality}, approved by the Committee on Fiscal Affairs on 28 June 2011, p. 5.} The exported goods are free of VAT, whilst imports are subject to the same VAT as equivalent domestic goods. Deduction of the VAT incurred at importation (vice-versa as input tax deduction on a domestic supply) ensures neutrality \textit{(i.e. limits distortions in international trade). Supplies of services and intangibles are more difficult for the destination principle. In their nature, both services and intangibles haven’t got any customs control (which can confirm their exportation and impose VAT at the moment of importation). A pure destination-principle VAT imposes tax on supplies of goods and services for domestic consumption, whereby the tax would be imposed on imports of goods and services because they are expected to be consumed domestically.}

\textbf{3.5.4 Principle of Origin}

The destination principle conflicts with the principle of origin. Under this principle, each jurisdiction would levy the VAT on the value created within the borders. A full application of this principle would mean that exporting jurisdictions would tax exports on the same basis (and same rate) as domestic supplies while importing jurisdictions on the other hand would guarantee a credit against their own VAT for hypothetical tax that would have been paid at the importing jurisdiction’s own rate.\footnote{Compare OECD, \textit{International VAT/GST Guidelines on Neutrality}, approved by the Committee on Fiscal Affairs on 28 June 2011, p. 5.} In this case, tax paid on a supply would then reflect the model of its origins, whereby the total amounts of
revenue would be distributed in this model. However this would contrast with one of the aforementioned principles of VAT: a tax on consumption. Since the idea of such a tax (on consumption) is that the revenue should accrue to the jurisdiction where the final consumption takes place. Under the application of the origin principle these revenues are shared amongst jurisdiction where value is added. The OECD remarks further that ‘In addition, as a neutral tax the total amount of VAT collected should not be influenced by the economic or geographical structure of the value chain. However, under the origin principle this amount reflects the various rates applicable in countries where value is added.’

The application of the principle of origin under VAT finds its statutory basis in the articles 33(1)(b) and 34(1) of the VAT Directive. These articles are applicable in the case where the goods are transported by or on behalf of a purchaser described as in Art. 33 of the VAT Directive. In this matter, the place of supply is the place where the transport to the consumer starts, if certain conditions are met.

No country employs a pure origin-principle VAT, which would tax domestic supplies of goods and services, imports are not taxed, but exports are taxed. This could be described as a production tax.

**Conclusion**

The current VAT system is based on the destination principle. In this respect the tax is effectively charged at the rate of VAT applicable where the buyer is established. In contrast, VAT would be charged at the rate in force where the supplier is established if the origin-based system was applicable. As was originally the plan, this would effectively abolish fiscal frontiers in the EU. The tax would be levied by the EU in Brussels and all Member States would have the same laws and tariffs. The revenue would be divided by Brussels amongst its Member States. Since the Community aims at establishing a common VAT system, which eliminates import taxes and exemption on export taxes in trade between the Member States. Hence the origin principle was most favoured.

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366 The purchaser is either a small undertaking or a taxable person subject to the flat-rate scheme for farmers and who does not have subject to his acquisitions for VAT; or a taxable person who only carries out supplies of goods and services in respect of which VAT is not deductible (*e.g.* a doctor) and who does not have to subject his acquisitions to VAT; or a non-taxable legal person who does not have to subject his acquisitions to VAT; or a non-taxable private individual.

367 The goods supplied are: not subject to excise duty; not new means of transport; and not supplied after assembly or installation, with or without a trial run, by or on behalf of the supplier. Also a threshold is applicable: the total value of such goods dispatched to the same Member State, excluding VAT, does not, in a calendar year, exceed the equivalent in national currency of EUR 100,000. The last applicable threshold is that the total value, excluding VAT, of such supplies of goods dispatched to the same Member State in the previous calendar year, did not exceed the equivalent in national currency of EUR 100,000.

368 See also Art. 402 of the Vat-Directive.
is non-discriminatory as regards the origin of goods and services: this would serve a real internal market. The intention is still an origin-based VAT system, where VAT is charged by the seller of goods. Since problems as differences of VAT-rates between Member States and the lack of an adequate mechanism to redistribute VAT receipts to mirror actual consumption could be agreed upon, the origin principle was not acceptable to the Member States.  

Currently, the EU has adopted a transitional system which is:

a) an origin based system for sales to private persons who can go and buy tax paid anywhere in the EU and take the goods home without having to pay VAT again (some exceptions are the purchase of new means of transport and distance selling).

b) a destination based system for transactions between taxable persons. This makes it possible to determine the exact amount of tax on a product at every stage of production and trade, and to clear exactly that amount upon exportation.

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3.6 Conclusion

Indirect taxation is considered to be very different from direct taxation. The characterization of as a direct or indirect tax merely relies on different techniques of taxation envisaged by the legislator: direct taxes are characterized by the presumed coincidence of the taxable person or tax subject, on the one hand, and the person effectively paying the tax or the final taxpayer on the other hand.

In contrast, an indirect tax is supposed to be shifted from the taxable person to a different person in the price of goods supplied or services rendered by the former to the latter, who thereby becomes the final taxpayer. Since there is no guarantee that indirect taxes will always be shifted, nor that direct taxes will always be borne by the taxpayer, this distinction rests preliminary on the conception of the legislator and the ensuing legal features of the tax.

Although it sounds nice to compare the direct with the indirect (VAT) field, practice has shown that it is much more difficult to compare them. In direct taxation the principles underlying the jurisdiction to impose taxes (i.e. the relevant principles of this research) in direct taxation are the source and residence principle. Under VAT these principle are the origin and destination principle. In this respect, the origin principle is logically analogous to source-country taxation. The destination principle appears at least at first sight, to be logically analogous to residence-country taxation. Several scholars draw this comparison between source and residence principle, on the one hand, and the origin and destination principle, on the other.

Despite the frequency of this comparison, it seems to be of little significance for three reasons. Millar lists the fact that ‘the origin principle is not a significant contender’ as first, since it is communis opinio that the destination principle should be used. A second reason why the analogy is of little relevance is because the origin taxation of supplies is equivalent to resident taxation of supplier’s income. From the point of view of the tax payer, the origin principle is in fact analogous

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370 Mill, Principles of Political Economy (1898) book V, chapter III;
372 Compare section 2.3. of this research.
375 Ibid.
376 Ibid.
to residence rather than source. On international levels, the taxation of consumption on a source basis (i.e. at origin) is equivalent to taxing the income of suppliers on a residence basis. In contrast, in the view of the supplier the principle of origin is more akin to residence taxation of income. This is another argument against origin-based taxation of consumption. If the arguments in favour of source country taxation of income on the basis of inter-nation equity ‘have any merit, then they must be equally applicable to consumption tax; and since taxing consumption is equivalent to taxing the income of suppliers on a residence basis, the inter-nation equity arguments should presumably favour taxing consumption on a destination basis’. 377 The last reason is that residence of consumer is not equivalent to destination. For the purposes of VAT, destination means place of consumption and thus not residence of the consumer. The fact that the practical effect of the destination principle often results in taxation of consumption where the consumer is resident, is due to the fact that consumers often consume goods in their country of residence. This has nothing to do with the fact that VAT sues customer residence as the basis for asserting substantive jurisdiction.

Despite the difficult comparison, the only item that could be relevant for the problem statement is the destination based system, which is inside the field of VAT much more supported than the origin-based system.

This idea is further elaborated for the direct tax system by Auerbach, Devereux and Simpson. 378

The motivator is that the allocation of tax between states still not occurs in accordance with the economic reality, as the current 1920s methodology fails to. 379 They propose an alternative method for the allocating of tax jurisdiction: a business income tax based on cash flows, i.e. the destination-based cash flow tax. 380 Such a tax would link up with goods supplied and services rendered by economic operators. It would basically function as a VAT system, on a cash basis, with a deduction for wages (labour costs). It would tax imports, but refund exports. The authors consider this principle will lower the opportunity for companies to shift profits between countries, thus making this principle less sensitive for aggressive tax planning. It would also enhance the allocation of production factors, which would be less distorted and more efficient. 381

377 Ibid, at 284.
381 Ibid.
The arguments in favour of the destination principle are convincing. The scale and location of investment and the use of different forms of finance would be unaffected by the tax; there’s no incentive to shift income to low-tax jurisdictions. Furthermore it would decrease the need for thin capitalization and transfer pricing rules. These ‘destination countries’ seems to have both substantive jurisdiction (i.e. the legitimacy to impose tax and the connection between the subject matter being taxed plus the noting imposing the tax) and enforcement jurisdiction (i.e. the practical and effective means of collecting tax).\textsuperscript{382} Under such a system, allocation of taxing rights would have to be based in principal similar to those applied under VAT: a place of supply rules-type system, with proxies in order to determine the place of destination.\textsuperscript{383} A country may only tax such transactions; the place of supply of which is located in this country’s territory.\textsuperscript{384} The destination principle determines that the tax is imposed only on the supply of goods or services to be consumed domestically. The place of supply on services supplied on the level of Business to Business (B2B) transactions is the place where the recipient of services is established.\textsuperscript{385}

\textsuperscript{382} On this distinction between substantive and enforcement jurisdiction see: Millar, R., \textit{Echoes of Source and Residence in VAT Jurisdictional Rules}: in: M. Lang (ed.) Value Added Tax and Direct Taxation, Similarities and Differences, IBFD, Amsterdam, 2009.


\textsuperscript{385} Art. 44 of the VAT-Directive. The other rules for the place of supply are to be found in Articles 31, 40 and 45.
4. Principles in international direct taxation

4.1 Introduction
After the relevant principles of indirect taxation has been set out in the previous chapter, the current chapter is dedicated to the relevant principles of (international) direct taxation. Therefore the ‘set-up’ will be basically the same as in the previous chapter. In this respect, the principle of neutrality can be seen as the ‘connection-factor’ between both chapters. Both chapters follow the way which has been set out in the legal framework of the second chapter.

The allocation of tax jurisdiction in the field of direct taxation is primarily based on connection factors, i.e. via the principles of personal and economic allegiance. From these connection factors the allocation principles will derive, as described in the second chapter. These ‘qualitative’ principles are more connected with the ‘quantitative’ principles of universality and territoriality, which will also be investigated in this chapter. Furthermore attention should be paid to the exemption and credit method.

4.2 Introduction to principles in international direct taxation
Principles can be considered as expressions of legal values, and constitute the normative foundation of law in general. International taxation requires the involvement of two or more countries (herein called ‘states’). Unfortunately there is no global tax system (for the world) that governs cross-border taxations; neither there has such thing as an ‘international court’ or any other related body existed. This results in conflicts between national jurisdictions of states that are involved in cross-border transactions. Within this level playing field, international taxation governs these domestic tax rules under customary international tax law and treaties.

Another function of international tax law is to support other objectives of domestic tax systems, these objectives thus related to cross-border transactions, normally including matters to:

- Promote fairness
- Enhance domestic competitiveness through fiscal measures and stimulating economic growth;
- Obtain a fair share of the revenues; and

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• Ensure an ‘equitable balance’ between capital import and capital export neutrality.\textsuperscript{388}

Enhancing these objectives is done via the allocation of tax jurisdiction through bilateral tax conventions between States.\textsuperscript{389} This allocation of right to tax is achieved by, or should be achieved by, legal principles in international taxation.\textsuperscript{390} In the following paragraph these principles will be discussed. In practice, this is the issue of worldwide versus source taxation, which is common to lawyers and economists.\textsuperscript{391}

The principles of international taxation are always influenced by tax equity and tax neutrality, within the national economic sovereignty of each State.\textsuperscript{392} The aspects of tax equity and tax neutrality will be discussed later on this paragraph. Important to mention is that both aspects, as the word ‘international taxation’ implies, depends on the cumulative effects of the tax laws of all countries, not on the national tax laws.

In short, this is the reason for conflicts in international transactions: simple because there’s shortage of harmonization in the global tax world. Although states are at different levels of social and economic development with accompanying fiscal needs which results in the fact that each country applies its own tax rules on transactions related to its jurisdiction, nevertheless on the other hand this unfortunately led to economic distortions and tax competition.\textsuperscript{393} Via international taxation both enforceability and reciprocity must resolve these conflicts, herby conflicting with the principle of sovereignty. Since the principle of sovereignty (an attribute of statehood or sovereignty) is considered to be the legal basis (principle of legality) to impose taxes therefore gives states \textit{mutatis mutandis} the right to allocate tax jurisdiction.\textsuperscript{394} Furthermore the right to tax is determined to be valid from a contribution of the relationship between individual and community,\textsuperscript{395} which is considered sufficient on the basis of political and/or economic connection with the state

\textsuperscript{389} Kemmeren, E.C.C.M., \textit{supra} note 17, at 11.
\textsuperscript{390} Ibid.
\textsuperscript{392} Ibid.
\textsuperscript{393} Rohatgi, R. \textit{Basic International Taxation, Second Edition, Volume I: Principles}, Richmond Law & Tax, Richmond (UK), 2005, p.1. In the author’s view, ‘countries do not follow a common definition of the tax base and provide different deductions and incentives at varying tax rates to taxpayers. Moreover, a return on investment can be realized through different forms of income (e.g. branch profits, dividends, interest, rent, royalties etc.) with different tax consequences’.
\textsuperscript{394} Compare e.g. Kemmeren, E.C.C.M., \textit{supra} note 17, at 18.
In this chapter I’d like to discuss the several different principles which are at the basis of the allocation of tax jurisdiction and (more specifically) to discuss their relationship with the two elementary aspects: the fairness and efficiency of tax systems.

As mentioned before, the two prevailing key principles in international taxation are the residence (citizenship in the United States) and source principles. According to Rohatgi both principles are primarily based on the ‘benefit theory’. Each jurisdiction has the right to tax for services rendered or benefits provided. In other words: each beneficiary of the State’s expenses in services should pay their fair share (i.e. tax) for it (see chapter 3). This ‘benefit theory’ is similar to what Kemmeren argues with ‘sufficient economic relationship’, which have to be present to assess whether a sufficient link of the assignment of tax jurisdiction is present; therefore there have to be a linkage between the ‘territory principle’ with the ‘direct benefit principle’. The latter principle, the direct benefit principle, has been further elaborated by Bruins et al. In their view the direct benefit principle is both part of the ‘faculty principle’ as of the principle of ability to pay, since a person’s wealth provides him or her with the ability to pay taxes. Instead of the term ‘ability to pay’, the literature prefers the term ‘faculty’ as the first might only refer to income taxes. The faculty principle implies horizontal (similar economic situations – similar treatment) and vertical equality (different economic situations – different treatment).

To conclude the direct benefit principle or benefit theory is, according to the literature, leading in international taxation. This principle is further elaborated or ‘giving substance via’ the principles

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396 Compare e.g. Rosembuj, T., *Personal and Economic Allegiance under the Personal Income Tax and Corporate Tax in Spain*, 26 Intertax 4-6 (1998).
397 Kemmeren, E.C.C.M., *supra* note 17, at 18. These are e.g.: citizenship, incorporation of a company under national law, domicile, residence, statutory seat of a company, place of effective management of an enterprise, permanent establishment, situation of land, and place of labor.
400 See Kemmeren, E.C.C.M., *supra* note 17, at 22.
These principles can be considered as qualitative principles, since they indicate whether there is a justification of principle to impose a tax. It should be noted that the issues discusses underlined are relating to direct investment, i.e. establishing entrepreneurial activities in another country.

4.3 Quantitative legal principles: Worldwide versus Source taxation

In designing a direct or indirect tax system, a state have to decide how geographically broadly it wants to assert its tax authority. This can be done under a worldwide or territorial principle, modification or combination of both. In the 1980s the world was divided into two groups: the major group consisting of most of continental Europe and most developing countries tax both residents and non-residents on a territorial basis (only domestic source income) while exempting foreign source income. The other group tax their residents on a worldwide basis while providing a foreign tax credit. This traditional division is reflected in the choice of the credit or the exemption method (Art. 23A and 23B OECD Model). Today there are no states with a pure worldwide or territorial tax system. Thus both tax policies are in practice often applied parallel to each other, embedded in a uniform tax system with possible varieties and deviations.

As a consequence of its sovereignty, a state's jurisdiction to levy direct taxes is established. Therefore a state will have to find connecting factors on the grounds on which its jurisdiction to tax can be justified. This right is restricted to persons having the nationality or have residence in a state and to persons who are present in or taxable items that are sourced in the territory of the relevant state; in other words: a link to the person who is subject to tax (whether this is a individual or a corporation) and to the taxable item. Besides this search, a state also has to prevent the avoidance of its jurisdiction to tax on the other hand. Although the connecting factors seems to more difficult to determine. Allocating tax jurisdiction is primarily guided via the OECD Model Tax Convention on Income and on Capital (hereinafter: OECD Model).

403 Kemmeren, E.C.C.M., supra note 12.
404 Ibid.
Traditionally, establishing jurisdiction is founded on the territorial and personal bases of jurisdiction.\(^{408}\)

As regards the right to tax, the persons or corporations place of residence or establishment or nationality can function as connecting factors. These are also called the personal principles of the jurisdiction to tax.\(^{409}\) These principles are elaborated further by means of the universality principle. On the other hand is the territoriality principle. This is related to the taxable item, and the principles to allocate tax jurisdiction are also known as the objective principles.\(^{410}\) This deviation is common as it is common to hear the tax world is divided into two separate groups of countries: a worldwide and source group, based on respectively the universality and territoriality principle.\(^{411}\) Traditional economists plead for the pursuit of efficiency either on a worldwide basis or on national wide basis.\(^{412}\) Both have their working mechanisms: the credit and the exemption method respectively. The true goal of both systems is to achieve CLEN and CLIN.\(^{413}\)

### 4.3.1 Universality principle

Worldwide taxation (or the universality principle) is derived from the qualitative personal principles of residence and of nationality. The universality principle implies that, if a person or company is established in a state, he may be taxed in that state on both his domestic and foreign-source income, or on his worldwide income.\(^{414}\) This is also related to the issue of the so-called exit taxes, which use this connecting factor of moving the personal principle.\(^{415}\) The method of avoiding double taxation is found in a tax system based on the tax credit method.\(^{416}\) In accordance with this method, the foreign source income is included in the tax base. This method gives the right to tax income and capital with preference to the state of residence of nationality of the taxpayer instead of the state of source. However, this does not imply that the state of source hasn’t got any right to tax. Moreover, sometimes it is possible that objective principles related to the source state play a role: in such case

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\(^{410}\) Ibid.


\(^{414}\) Bender, T., *De vrijstellingsmethode ter voorkoming van internationale dubbele belasting*, Leyden University, The Netherlands, diss. 2000, pp. 18-22.


\(^{416}\) Kemmeren, E.C.C.M., *supra* note 17, at 50.
the primary right to the tax is in the state of source while that state applying the universality principle via the personal principles take the foreign paid taxes into account.\(^{417}\) This tax credit method is one of the options left to contracting states in both the OECD Model and UN Model, via the ordinary tax credit. This ordinary tax credit limits the foreign tax credit to the amount of domestic tax attributable to the foreign source income.\(^{418}\)

### 4.3.2 Territoriality principle

The territoriality principle is a more limited application of the territory principle, and implies that the connection is determined by the income earned or capital situated in that state, \textit{i.e.} economic factors. Taxation based on territoriality according to Vogel among others remarks that important reasons of individual equity plea for exclusive taxation of foreign domestic income in the state in which the investment is made, \textit{i.e.} the source state.\(^{419}\) So does inter-nations equity.\(^{420}\) Thus the territoriality taxation via exclusive source or origin/economic location should be accepted when the benefit theory is linked with the territory.\(^{421}\) Under the territoriality principle, the tax credit system is not present. The capital or income is to be excluded from the tax base in the other contracting state: the so called base-exemption. However, there’s another form of exemption: the modified exemption. In the literature the effects of both exemptions are often considered to be equal.\(^{422}\) According to Kemmeren, they are not.\(^{423}\)

There should be noted that in practice the distinction (exemption method is applied by countries using the territoriality principle respectively credit method for countries using the universality principle) is less clear-cut. Actually, no country operates purely on one of the two systems, almost all of them mix both methods. Therefore all systems have a hybrid character.\(^{424}\)

The connecting factors for the territoriality principle are the so-called objective quality principles ‘origin principle’\(^{425}\) and the source principle.\(^{426}\) Although the literature does not always make the

\(^{417}\) \textit{Ibid.}  


\(^{419}\) Vogel, K., \textit{supra} note 13 at 398.  

\(^{420}\) \textit{Ibid.}  

\(^{421}\) Kemmeren, E.C.C.M., \textit{supra} note 17, at 52.  


\(^{423}\) Kemmeren, E.C.C.M., \textit{supra} note 17, at 52.  


\(^{425}\) Although the term ‘the principle of origin’ will be used in this research, \textit{the} principle of origin does not exist in law, see: Kemmeren, E.C.C.M., \textit{supra} note 17, at 5.  

distinction between these two principles, it is evident that they are not the same. Under the principle of origin, taxation of a state is justified if the income is created within the territory of that state, or in other words: the cause of income is within that state. The principle of source allocates the right to tax to a state because a certain source is located in that state. The difference between both principles can be made clear with the following example: when a dividend is paid, the shares (the source) may be in a certain state (where the company is established), but this does not mean that the profits (from which the dividend arises) have their origin in that same state.

4.3.3 Exemption versus credit method
The exemption method excludes the income from the taxable base of the country of residence. The credit method, the foreign source income includes it. We can distinguish two methods: full inclusion and deferral regime. In the first method the foreign source income is taxed on a current basis, as soon as it is earned abroad, while in the latter the income is not taxed until it is actually repatriated into the home jurisdiction. Both systems generally allow the country of residence a credit for the foreign tax. The foreign tax reduces the income tax computed on the foreign income giving rise to the reduction (ordinary credit method), or on the income tax due with respect to all income, whether or not foreign sourced (full credit method). Only the latter is a pure form of the CLEN, while only the pure exemption method is a pure form of CLIN.

For dividends on substantial shareholdings in foreign companies (non-portfolio dividends), certain countries grant a credit for underlying foreign taxes paid at the level of the foreign company on the profits out of which the dividends are paid (indirect tax credit). Finally, the country of residence may grant a credit equal to its own tax computed on the relevant foreign source income, in which case the credit amounts to an exemption.

428 Ibid. At 35.
<table>
<thead>
<tr>
<th>Credit Method</th>
<th>Exemption Method</th>
</tr>
</thead>
<tbody>
<tr>
<td>+ Low sensitivity to allocation of deductions between domestic and foreign sources</td>
<td>Equity</td>
</tr>
<tr>
<td>+ Ability to deduct foreign losses against domestic income</td>
<td>Efficiency</td>
</tr>
<tr>
<td>+ Relatively low level of tax planning</td>
<td>Simplicity</td>
</tr>
<tr>
<td>- Complexity inherent in foreign tax credit limitation rules</td>
<td>General prohibition on deducting foreign losses from domestic income</td>
</tr>
<tr>
<td>- Complications of credit provisions looking through complex ownership structures</td>
<td>Detailed expense allocation rules generating risks of double taxation</td>
</tr>
<tr>
<td>- High administrative burden</td>
<td>Greater sensitivity for tax avoidance</td>
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* (note that states never adopt the pure or ideal form of the credit/exemption method)

However, since credit and exemption may generate similar risks of double taxation, as evidenced by all the potential conflicts deriving from problems between the country of source and country of residence with respect to the source or the nature of the taxable income, the effects mentioned above regarding tax planning and tax avoidance might be skimmed.

**4.3.4 Universality versus territoriality principle**

A pure application of the universality principle promotes CLEN since it does not distort the decision of whether to locate investment at home or abroad. Besides this it also promotes both horizontal and vertical equity. The first to the extent that it treats taxpayers earning comparable incomes similarly, while it considers vertical equity by imposing progressive taxes on the ability to pay principle (total income earned by taxpayers) wherever earned. The application of the universality principle implies the taxation of the taxpayer’s worldwide income by granting a (full) tax credit, which thus serves the principle of CLEN.

A pure territorial tax system promotes CLEN, it treats all investment within a particular source country the same, regardless of the residence of the investor. Thus taxing only income derived within that state, irrespective of the residence of the taxpayer. In form, a pure territorial system is simpler to administer and comply with. The disadvantage is that it encourages the shifting of investments and activities to low-tax or tax haven countries and requires anti-deferral rules to prevent residents from engaging in these activities. The territoriality principle exempts the foreign income and capital from the taxpayer’s tax base, thus based on the principle of CLIN. As mentioned before the use of the
The territoriality principle is, according to Vogel among others, support important reasons of individual equity thus plea for exclusive taxation of foreign domestic income in the state in which the investment is made, *i.e.* the source state.\(^{429}\) So does inter-nations equity.\(^ {430}\) Thus the territoriality taxation via exclusive source or origin/economic location should be accepted when the benefit theory is linked with the territory.\(^ {431}\) As before the benefit principle was considered to be the predominant factor for justifying taxation, the use of the territoriality principle should prevail over the universality principle.

### 4.4 Qualitative legal principles

The four economists, in 1923, after discussing the various nexus factors for corporate shares – origin, situs, enforceability and domicile, decided that the predominant argument is in favor of domicile. These arguments are today completely outdated. In order to determine the right to tax with respect to the tax subject, the qualitative principles function as the connecting factors between the subject and the states territory with respect to the allocation of tax jurisdiction regarding income and capital. These qualitative principles are also considered to be of a legal nature.\(^ {432}\) The principles are still the same principles as in 1923, *i.e.* nationality (which includes for this research also citizenship, incorporation), residence (or domicile), source, origin and functionality. For time sparing reasons the principle of functionality will not be discussed in this research. The four principles can be divided in two groups: the ones related to the personal principles, *i.e.* the principles of nationality and residence, and the ones related to the objective principles, *i.e.* the principles of source and origin. Whereas the first aim at linking the personal allegiance with tax, the latter use the economic allegiance.

#### 4.4.1 Personal allegiance

Personal allegiance refers to the link between an individual and the territory through personal circumstances. This section explains the various situations in which, due to personal allegiance, an individual is subject to taxation. These are personal taxation principles that refer specifically to the person of the taxpayer.\(^ {433}\)

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\(^{429}\) Vogel, K., *supra* note 13 at 398.

\(^{430}\) *Ibid.*

\(^{431}\) Kemmeren, E.C.C.M., *supra* note 17, at 52.

\(^{432}\) Kemmeren, E.C.C.M., *supra* note 17, at 27.

\(^{433}\) Raad van, C. *Internationaal Belastingrecht*, Student-edition, 2011, p.44.
4.4.1.1 Nationality

Nationality is conferred on an individual by a state pursuant to its domestic law.\textsuperscript{434} It reflects a personal attachment to a certain state. It has nothing to do with economic considerations. For corporations this principle of nationality implies that this legal person has the nationality of a certain state. This recognition is generally based on the incorporation (or siege reel) principle. The incorporation principle can be applied \textit{mutatis mutandis} to the principle of nationality.\textsuperscript{435} Hereby a corporation derives its rights (from the laws of that state) where it actually has its principal place of management, depending on both social and economic relationships. Liability on the grounds of nationality means to tax the full worldwide assets, irrespective of the source.\textsuperscript{436} It is often defended that this principle is not appropriate for allocating tax jurisdiction rights.\textsuperscript{437}

4.4.1.2 Residence

The principle of residence of natural persons and the establishment of corporations is one of the most important connecting factors in allocating the jurisdiction to tax. Residence is the connecting factor that gives substance to the principle of universality. As a matter fact, the state of residence is often considered to have the right to tax, which implies that the state of origin has to waive part of its jurisdiction. The benefits are considered to be ‘easy assessment, audit and execution of the obligations of the taxpayer’.\textsuperscript{438}

However, the current globalization and development of E-commerce questions the use of the principle of residence, as \textit{e.g.} intangibles are difficult to deem a place of residence. As long as individuals are concerned, it might be (despite the globalization) still possible to identify their place of living and their connection to a politically organized society.\textsuperscript{439} Since this research focuses on corporations (and in particular multinationals) the story is a lot different. It is far easier for multinationals to move their residence around. Although requirements as ‘central management and control’ do exist (which can be easily divided among jurisdictions), it is not required to have a

\textsuperscript{434} Kemmeren, E.C.C.M., \textit{ supra} note 17, at 27.
\textsuperscript{436} Martha, R.S.J., \textit{The Jurisdiction to Tax in International Law}, Deventer, Kluwer Law and Taxation Publishers, 1989, p. 49.
\textsuperscript{437} \textit{Ibid.}
\textsuperscript{438} Kemmeren, E.C.C.M., \textit{ supra} note 17 at 31 plus references at 99.

However the ‘residence’ of a corporation is still both decisive for the worldwide tax liability of this entity as for the application of tax treaties, see Art. 4(1) and (3) OECD Model. The problem with the principle of residence is in essence due to the ‘double-sided’ nature of the corporate income tax, which operates as a prepayment on the income tax of the shareholders.\footnote{Ibid.} Hence this would reflect the ‘residence’ of the underlying shareholders of the corporation (in the past the residence of the corporation was more or less identical with the residence of its shareholders). With respect to multinationals, whereby the shareholders are located abroad, the corporate income tax works as a ‘source tax’: a tax on the operating profit before it is paid out as a dividend to the shareholders or to the parent company abroad.\footnote{Auerbach, A.J., (ed.), \textit{Taxing Corporate Income}, Paper prepared for The Mirrlees Review, \textit{Reforming the Tax System for the 21st Century}, March 2008, p. 18 et seq.}

The result is that the conclusion that taxation with respect to the location of a corporate headquarters (or the country of incorporation) is a ‘strange mixture of residence and source taxation at the same time’.\footnote{Schön, W., \textit{International Tax Coordination for a Second-Best World (Part I)}, World Tax Journal, October 2009, p. 69.} The example of Schön is striking in this respect: a corporate group structure whereby the shareholders are residents of country A (final consumers), parent company of county B and the subsidiary of country C (profits are generated). Under the worldwide taxation based on the principle of residence county B will levy corporate income tax on the subsidiary’s profits when they are distributed to the parents company, irrespective of the final consumers or generating of profits.\footnote{Ibid.}

In the past the place of residence has always been considered to be far away from personal allegiance, but closer to economic allegiance (on the other hand).\footnote{Professors Bruins, Einaudi, Seligman and Sir Josiah Stamp, \textit{Report on Double Taxation}, submitted to the Financial Committee, League of Nations, Geneva, April 5th 1923, E.F.S. 73 (F.19) pp.19.} Thus, according to some authors the principle of residence is considered not to be the principle with the strongest right to justify tax jurisdiction for a certain state.\footnote{Kemmeren, E.C.C.M., \textit{supra} note 17 at 31.} Thus the principle of residence offers a basis with respect to consumption of income and capital, rather than with respect to generation of income and possession.
of capital.\textsuperscript{447} Taxation on the basis of the residence principle is considered to be equal to the principle of origin, thus they are also complementary.\textsuperscript{448}

\subsection*{4.4.2 Economic allegiance}

As with personal allegiance, economic allegiance is related to the link with a state’s territory through economic circumstances. Sometimes tax subjects are linked to a particular country not merely through their personal circumstances, but also due to economic factors. This section explains the different situations in which an individual is taxable in on the basis of his/her economic allegiance with the territory. These are called \textit{business taxation principles}, and correspond to the object of taxation.

\subsubsection*{4.4.2.1 Source}

The principle of source for allocating tax jurisdiction a certain source is taxed by a state because the source is located in that state, or is owned by someone who is resident or established in that state. The difference with the origin principle has already been made clear. However, the principle is often used in various meanings in the literature.\textsuperscript{449} Among these various meanings of the principle of are \textit{e.g.}: where the property is located or used; services are performed or have their effect; contracts are signed or executed or whose laws govern the contract; with which identity of payer is linked; where the payer is located; from where the payment is made; state which bears the expenses. Surprisingly the term ‘source’ is not often used in Double Tax Conventions, while the term ‘residence’ is often mentioned in legal documents.\textsuperscript{450}

It is commonly accepted is that the principle of source is an elaboration from the principle of location of wealth (also known as \textit{situs}): a person who receives income from a person or property situated in a state has such close relationship with that state in which the person or property is physically located that it justifies an obligation to support that state.\textsuperscript{451} The same applies to property; the allocation of tax jurisdiction is entitled to the state where the property is physically located.

\begin{footnotesize}
\begin{itemize}
\item \textsuperscript{447} \textit{Ibid.}
\item \textsuperscript{448} Weber, D.M., \textit{supra} note at 115.
\item \textsuperscript{449} Kemmeren, E.C.C.M., \textit{supra} note 17 at; Rosembuj, T., \textit{Personal and Economic Allegiance under the Personal Income Tax and Corporate Tax in Spain}, 26 Intertax 4-6 (1998).
\item \textsuperscript{450} Vogel, K., “State of Residence” may as well be “State of Source” – There Is No Contradiction, Bulletin for International Taxation 59, 2005
\end{itemize}
\end{footnotesize}
However, this allocation or situs should be distinguished from the real economic situation.\textsuperscript{452} The income may be generated (or property located) and preserved in another state different than in which a person actually resides generates his income (or has his property).\textsuperscript{453} Therefore the principle of source may not serve as the primary justification for allocating tax jurisdiction, although it might be more appropriate than most principles as it is closely connected to the economic allegiance.\textsuperscript{454} Especially with regards to intangibles, it is often impossible to determine a physical location, while with regard to capital tax it might be possible that another state than from the state where the share is located provided the framework for the possession of wealth. Mostly due to the upcoming E-commerce which appears the commonly accepted assumptions about economic presence quite meaningless.\textsuperscript{455}

Perfect example of this situation is the difficulty to determine respective contributions of different units of the firm to the final outcome, reflected prominently in the debate on the transfer pricing methods.\textsuperscript{456} This could be described as the erosion of the source concept.\textsuperscript{457}

4.4.2.2 Origin

The application of the principle of origin as a connecting factor for allocating tax jurisdiction implies the use of the origin of income. This is derived from the territoriality principle, by taxing income based on their origin. The use of this principle as a connecting factor implies that the income may be taxed by a state if this income can be allocated to it, thus sufficient nexus with the territory is required. This may result in a limited tax liability for non-residents for income that can be allocated to a source in the state of non-residence. Therefore a country is allocated taxing rights if the income in question came into existence on its territory, which includes the benefit from economic facilities, which are used for creating the income.\textsuperscript{458}

The common opinion is that this results in a globally accepted division of jurisdiction. However, for some types of capital it is difficult to determine their origin, as a result they might be remain

\textsuperscript{452} Ibid, at 433.
\textsuperscript{453} Kemmeren, E.C.C.M., supra note at 27-35.
\textsuperscript{454} Ibid.
\textsuperscript{455} Schön, W., International Tax Coordination for a Second-Best World (Part I), World Tax Journal, October 2009, p. 68.
\textsuperscript{456} Ibid.
\textsuperscript{458} Vogel,K., supra note at 216-229, supra note at 310-320 and supra note at 393-402.
untaxed. In his doctoral thesis Kemmeren proposes solutions for this problem in order to achieve a balanced system on the basis of a correct application of the principle of origin.\textsuperscript{459} As mentioned earlier, taxation on the basis of the residence principle is considered to be equal to the principle of origin, thus they are also complementary.\textsuperscript{460} This combined application might the disadvantages of the principles of origin disappear, whereby income that cannot be allocated to a certain territory will be taxed in the state of residence.

Kemmeren advocates that taxation based on the principle of origin will better serve the principle of ability to pay.\textsuperscript{461}

4.5 Anti-avoidance

As already been pointed out in paragraph 3.8 (Anti-avoidance and VAT) there is no particular provision concerning anti-avoidance in the field of direct taxation, although some particular fields are regulated. There are provisions concerning anti-avoidance in directives in the field of direct taxation, like for example Art. 11(1) (a) in the EC Directive 90/434.\textsuperscript{462} Tax avoidance is to be considered as the assessment of domestic tax avoidance measures in the light of freedom of establishment. The ‘difficulty’ with tax avoidance consists of the fact that However some case law exists. In 2006 the ECJ gave its ruling concerning the general legal principle prohibiting abuse of rights in the Cadbury Schweppes case.\textsuperscript{463} In this case the ECJ held that in order for a restriction on the freedom of establishment to be justified on the grounds of preventing abusive practices, the specific objective of such as restriction must be to prevent conduct involving the reaction of wholly artificial arrangements which do not reflect economic reality.\textsuperscript{464} However, the purpose of benefiting from more favourable legislation in a different Member State does in itself not constitute a violation of the freedom of establishment.\textsuperscript{465} In order to find such artificial arrangement there must be a subjective element in the intention to obtain a tax advantage plus objective circumstances showing that the objective pursued by the freedom of establishment has not been achieved.\textsuperscript{466}

\textsuperscript{459} Kemmeren, E.C.C.M., supra note.
\textsuperscript{460} Weber, D.M., supra note at 115.
\textsuperscript{461} Kemmeren, E.C.C.M., supra note 17, at pp. 568-570.
\textsuperscript{462} Council Directive 90/434 of 23 July 1990 on the common system of taxation applicable to mergers, divisions, transfers of assets and exchanges of shares concerning companies of different Member States, OJ L 225 1990.
\textsuperscript{463} ECJ, 12 September 2006, Case C-196/04, Cadbury Schweppes Overseas Ltd v. Commissioners of Inland Revenue (Cadbury Schweppes), [2006] ECR I-7995.
\textsuperscript{464} Ibid, at paras. 3 et seq.
\textsuperscript{465} Ibid, at no. 42.
\textsuperscript{466} Ibid., at para. 64.
4.6 Conclusion

In the world of international tax law, the qualitative principles are the connecting factor for the allocation of tax jurisdiction to a certain state to tax. These principles are the principle of nationality, residence, source and origin of income; all of them are also used to prevent tax-avoidance. To achieve tax neutrality, states take either the CLIN or CLEN as the point of departure for the elimination of double taxation.

Within the qualitative principles, a distinction is made between the personal and objective principles. They are both based on quantitative principles. The first is based on the universality principle and thus consist of the principles of nationality and residence. These principles take as their starting point the personal allegiance of a taxpayer with a state. This means that when a taxpayer has the nationality of a certain state or its residence or place of establishment, he will be taxed in that state for his worldwide income. Hereby nationality is used less often than residence.

The objective principles to determine tax liability on the other hand, are based on the territoriality principle. This means that a state only taxes income that has a sufficient nexus with its territory. The connecting factors thus are related with the economic allegiance. All of the connecting factors are used in anti-avoidance measures.

To achieve tax neutrality and avoid double taxation, the universality principle makes use of the credit method. The view is that this in consistency with CLEN. The territoriality principle on the other hand, prefers the use of the exemption method, aiming at CLIN. In the prevailing view, the allocation of production factors for tax reasons is considered to be inefficient; however this theory is heavily criticized nowadays. An efficient worldwide allocation of production factors will be supported by tax competition. Other values, like equity, may justify a deviation from this theory.

It can be defended that the credit method although is considered to be less efficient that the exemption method, is better to combat tax avoidance. This can be clarified by the historic use of the credit method, which had the function of an anti-avoidance measure. Recent CFC developments and legislation can be justified on the basis of CLEN.

Both the quantitative and the qualitative principles are considered to be legal principles, whereas the quantitative principles of universality and territoriality in practice make use of economic principles, i.e. CLEN and CLIN, via the credit or exemption method. Their goal is to achieve tax efficiency via tax neutrality and combat tax avoidance. The quantitative principles are used to justify the allocation of tax jurisdiction to a certain state. Their goal is to achieve tax equity.
5. EUCOTAX Comparative analyses

The core of this chapter is the comparative analysis based on the Wintercourse conference in Lodz. As mentioned before, the participating EUCOTAX countries of the theme “principles and standards of transnational taxation” were France, Germany, Italy, The Netherlands, Poland, Spain, Sweden and the United States. During this conference, the questionnaires (the guidelines for making a domestic profile of these countries) were discussed. From this discussion, several themes were highlighted: (i) the concept of worldwide versus source taxation in the different countries, (ii) the use of principles for allocating tax jurisdiction, and (iii) the approaches used to prevent and eliminate double taxation in relation with tax efficiency. These themes will be discussed in the upcoming paragraphs. This research will start with a Dutch point of view, followed by a comparison.

5.1 Quantitative and qualitative legal principles

The principle of sovereignty implies that each country can freely choose the criteria connecting the material element of the taxable event with the scope its taxing power. Although complete exercise of sovereignty is hardly possible. This is because of the limitations created by the effects of globalization and by explicit and implied pressures exerted by other countries.

The principle of source and domicile are basically the traditional jurisdictional principles. The residence principle is generally known as to have “unlimited tax liability”. Since it taxes persons (residents) on all of their income, this is a logical term. On the other hand the source principle is generally known as “limited tax liability”, it only taxes income (or property) originating in or related to the taxing country.

5.1.1 Netherlands perspective

The Netherlands traditionally follows the universality principle via the principle of residence, whereby taxing its residents on their worldwide income. Herein follows the Netherlands the classic distinction between actively and passively received income. Whereas business profits and income from services are considered to be actively received income, income from portfolio investments are considered to be passively received income. For the first group, i.e. actively received income, the principle of source prevails. In contrast, the Netherlands gives priority to the principle of residence for actively received income.

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467 This criteria is known as the jurisdictional connection to the taxable event.
5.1.2 Comparison

Based on the papers of Eucotax colleague students, it is possible to draw a distinction between three groups of reporting countries. The first group has a system primarily based on worldwide taxation. Actually this group consists of one state: the USA. As already mentioned, the USA has adopted a worldwide system of taxation. In general US taxpayers (including US citizens, resident individuals and corporations) are taxable on their worldwide income, subject to a credit for qualified foreign taxes paid or deemed paid. Thus it applies the credit system on both active and passive income, including dividends from subsidiaries. It also taxes foreign source income generated by foreign subsidiaries, upon income repatriation. The exemption method may be applicable in limited cases, thus only in treaty context.

The second group consist of three states that adopted a truly hybrid system. Herein foreign business income is only taxable in the state of residence even if earned through a foreign branch. In this case the credit system applies. Although the income is exempt if it is received in the form of a dividend deriving from a foreign subsidiary. This is because of the switch of the domestic legislation to the exemption system. This group is consists of Germany, Poland and Sweden.

The last group (France, the Netherlands, Spain and Switzerland) includes four countries which are traditionally regarded as following the territoriality principle. These countries exempt profits from foreign branches, together with dividends from foreign subsidiaries, and apply the credit method for passive income. This in a domestic or treaty context. Like previously mentoined, a number of countries applying a credit method have partially moved to the exemption method with respect to non-portfolio dividends. Thus the classification of certain countries could be questioned, or at least qualified, in particular cases for those which exempt branch profits in a treaty scenario and intercompany dividends under domestic law.

5.2. Qualitative legal principles

5.2.1 Principle of Nationality

The EUCOTAX-countries do not use the nationality of natural persons as a connecting factor in order to give effect to the universality principle. Also the nationality of entities (i.e. making a link to the law of incorporation, a.k.a. seat requirement) is generally as a connecting factor. However some countries (the Netherlands and Germany) make use of the nationality of certain entities, in addition to their place of establishment, as a connecting factor for the universality principle. One exception is to be found in the United States of America. The US does accept nationality in taxation as a general
connecting factor for the universality principle.\textsuperscript{469} The OECD Model ordered the principle of nationality as the last one to determine in which state a person is considered to be a resident.\textsuperscript{470} Art. 19 of the OECD Model hold an exception based on the nationality requirement with respect to consular relations. This can be also seen in the \textit{Gilly} case.

5.2.2 Principle of residence

As mentioned before, residence is the connecting factor that gives substance to the principle of universality. Thus, most countries tax their residents on their worldwide income. In addition, they apply the territoriality principle to non-residents, which means that non-residents are only taxed by a state if certain kinds of income can be attributed to that state. Both forms are known as unlimited respectively limited tax liability. Corporations may be taxable in a country based on the domicile principle, meaning the company is resident in that state. The criteria which will determine whether or not a company will be resident, and so taxable, can differ from one country to another, and a company could be considered as a resident in more than one state. The resident country entitled to tax will usually be (1) where the company has its seat of management or (2) where it is registered or incorporated. Among the European countries, both these methods are used by different countries. In some situations, one of these methods might be the general method, while the other method is a subsidiary method used for tax treaty purposes.

The registration method is used in Sweden, for example. This means that a corporation will be liable for unlimited taxation in Sweden if the company is registered in Sweden in accordance with Swedish corporation legislation. The registration method is also used in the U.S by incorporation on both the state and federal level. A corporation is “domestic” under U.S. law if it is “created or organized in the United States or under the law of the United States or of any State...”\textsuperscript{471} Almost all U.S. corporations are a product of state, rather than federal, law. Any corporation incorporated elsewhere will be a “foreign corporation”, regardless of its principal office or place of management\textsuperscript{472}.

By contrast, the seat method is used in Germany. This can be expressed as “\textit{resident companies are those companies, which have their legal seat in that country}”.

Effective management is a third method for determining residence. In addition, it is used as the tie-breaker for determining residence in the OECD Model Convention, article 4.3. However, not all countries recognize effective management as the basis for residence of a corporation. When such

\textsuperscript{469} US Internal Revenue Code, paragraph 871 and 877.
\textsuperscript{470} See art. 4(2)(c) OECD Model Tax Convention.
\textsuperscript{471} U.S. Internal Revenue Code § 7701(a)(4); IBFD - Corporate at § 1.2.1.
\textsuperscript{472} Gustafson at 56-57; IBFD – Corporate at § 1.2.1.
countries are given the right to taxation by a tie-breaker rule, they may fall back on the registration or seat method when taxing the corporation. Countries that recognize effective management are, for example, the Netherlands, Switzerland, and Italy. This method tends to favour economic reality rather than formal criteria. In the Netherlands, effective management is decided under the facts-and-circumstances test, which has been shaped by case law. Apart from other considerations the Court will regard the location of the: e.g. registered office; directors meeting; shareholders meeting; business operations; headquarters; law under which the entity is established; and location of the accounts.

With the world becoming more global, the different treatment of the domicile principle may lead to double taxation. This could be the case where one country bases taxation on the ground of company seat, at the same time as another country bases taxation on the place of effective management. An ideal situation would therefore be that all countries use the same method for determining residency. All methods can be used for this purpose; however, to limit the possibilities for tax avoidance, effective management could be viewed as the preferred method.

5.2.3 Principle of source

Many countries have no particular source rules in their domestic legislation, often the concept of source is very broadly defined. In Spain, more radically, there is no definition of the source of income. Other countries, mainly credit countries such as the USA, have implemented very detailed source rules.

No country has a tax system completely based on the source principle. France is the only country which has a territoriality provision for active income taxation (“only profits made by enterprises operated in France are liable to corporation tax”). The term “enterprise operated in France” means an enterprise which carries on a regular business in France, whether in an autonomous establishment or, if there is no establishment, through representatives without independent professional status, or as part of operations forming a complete business cycle.

This means that profits made by a French company in enterprises operated in countries other than France are not liable to French corporation tax; likewise, a foreign company is liable to French corporation tax only on the profit made from enterprises which operate in France. Consequently, companies liable for tax in France may not deduct losses made by enterprises they operate in other countries from their taxable profit.
From a theoretical perspective, it has been argued that, should all countries adopt source-based taxation on an exclusive basis, there would be no need for double tax treaties because income would be levied only once in the source country. However, since the criteria of source may differ between countries, conventions would still be necessary. An inappropriate source analysis may cause either residence state tax erosion, by exempting income which should be taxed, or permit excessive tax credits for income which has not been taxed at source. It may also treat an insufficient amount of income as foreign source and therefore cause international double taxation by not allowing exemption (under the territory principle) or not granting a foreign tax credit (in a worldwide tax system). In addition, source rules may attribute the income to a source located in a foreign country different from the foreign country taxing the income, in which case the foreign tax credit may be lost, in particular if the state of residence has introduced a per-country foreign credit limitation: the Netherlands, Spain, Germany and the USA. By contrast, in credit countries which do not calculate foreign tax credits on a per-country basis, sourcing the income is generally irrelevant. In Spain, in the absence of any treaty, a unilateral credit may be granted wherever the source of the foreign income is located. It is sufficient to demonstrate to the Spanish tax authorities that the income has been taxed in the source country and is also taxable in Spain. The same rules apply in Sweden.

5.2.4 Principle of origin

As the principle of origin has not been included in the papers; this will not be discussed in this chapter. For an analysis, see other chapters.

5.3 Elimination of double taxation in relation with efficiency

5.3.1 Netherlands perspective

The Netherlands is a country with a small internal, but with a big foreign market. Therefore the system is characterized by openness for foreign investments. The principle of neutrality is important. In this respect, exemption method as a method for the elimination or preventing of double taxation is the leading method.

To prevent double taxation, the Netherlands uses the following systems:

Exemption (with progression) method for ‘active’ income individuals in direct taxes, the Netherlands uses the differentiation which is commonly accepted between actively received income and passively received income. With respect to the tax jurisdiction on actively received

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473 General Report, IFA 2005, Angel Schindel and Adolfo Atchabahian
474 Kemmeren, E.C.C.M., supra note 17, at 105.
475 Ibid, at 60.
income, the source state prevails. In such cases, the Netherlands normally grants parent companies a tax base exemption under the participation exemption with regard to dividends from and capital gains on shares in qualifying companies. This is clearly an example of the application of the territoriality principle.\footnote{Ibid.} A modified exemption, a tax exemption with progression, is granted with regard to other actively received income.\footnote{Arts. 13-13h CITA.} According to Kemmeren this is an example of the CLEN principle. A profit exemption is guaranteed for ‘active’ foreign PE’s of companies and foreign real estate: profits and losses are exempt. For passive PE’s will apply the credit method instead of the exemption method. Final losses are still deductible.

The credit method applies for dividends, interest and royalties. In contrast, the Netherlands gives priority to the residence principle with respect to passively received income. The state of residence of the income recipient is provided with unrestricted tax jurisdiction. Ordinary credit is given for these types of income. In this category one can find also exceptions to the modified exemption method have been made with respect to the income of athletes and to income from personal activities, pensions and other similar, non-periodical remunerations. With respect to such income, an ordinary tax credit is provided.\footnote{Art. 24, paragraph 3, NL Model.} Lastly, a deduction of foreign taxes as cost is also a method for avoiding double taxation. Under the exemption method, it is not possible to opt for cost deduction. This can only be done if part of the foreign income is eligible neither for tax exemption nor for tax credit. In the case of profit from business, it is then possible (Article 3.2 et seq. PITA) to deduct the foreign tax paid as costs on the revenue obtained.

5.3.2 Comparison

For the sake of consistency this research will again begin with comparing the USA. The US system implemented through domestic legislation generally adopts a credit method. This applies to qualifying foreign income taxes paid. For corporations, an indirect foreign tax credit will also apply to income taxes deemed paid on dividends from a foreign subsidiary. The US has a limited exemption method for certain individuals living and working abroad. Traditionally, Spain has also adopted also the credit method and the underlying tax credit (for dividends) in order to avoid international double taxation. The exemption co-exists with the credit system (the taxpayer may opt for one or the other, although the application of both is incompatible). In Hungary, the double taxation may be excluded unilaterally or on the basis of a treaty. Unilateral withholding tax unilaterally applies to 90 per cent of the tax amount paid (payable) abroad and it may not exceed the amount of the tax levied in
accordance with the Hungarian regulations. Nevertheless the credit method prevails in some jurisdictions, especially where the policy is to protect the domestic market and ensure neutrality between residents. This is better known as Capital Labour Export Neutrality. On the other hand the exemption method’s goals of creating more neutrality for entrepreneurs plus to attract foreign direct investment while stimulating competitiveness. This is better known as Capital Labour Import Neutrality. This is in theory. But empirical comparison of foreign-source passive income treatment shows deviations with the US, Germany, Sweden\footnote{Participation exemption on dividends also possible}, The Netherlands and Switzerland being the appliers of a purely credit-based method an all qualified foreign taxes paid with respect to dividends, interests and royalties (“DIR”)\footnote{Although Germany applies a credit method in general on DIR, interests and royalty income paid to a related company being resident in a member state of the EU are exempt.} while Spain and France were identified to have a pure exemption method. Hungary (DR – exemption, I – credit) applies a mixture of methods.

On a national level treatment of passive income differ to a large extent. The US sources DIR to the place of incorporation/resident payer/place of intangibles used respectively, applying no withholding tax in the domestic context. The Netherlands stands out with no withholding tax on royalties and interests, while sporting 15% rate on dividends. Spain (D: 19%, I: 19%, R: 24%), Hungary (D: 16%, I: 16%, R: 27%), France (D: 19%-30%-55%, I:), R: 33,33%), Poland (D: 19%, I: 20%, R: 20%), Switzerland (D:; I:;R:), Sweden (D:30%,I:no:,R:26,3%), Germany (D: 25% (plus 5.5% solidarity surcharge; effective tax rate: 26.375%), I: generally no tax, R: 15% (plus 5.5% solidarity surcharge; effective tax rate: 15.825) apply withholding tax on all types of passive income.

5.3.3 Sovereignty, rule of law implications of neutrality solutions
Disparities between tax systems based on the worldwide and source principle are often used for tax-planning incentives, especially on the cross-border flow of passive income by switchover mechanisms. For example these incentives arise in France, Germany, The Netherlands and Sweden. This is because this is through a limitation on interest deductibility. On the other hand thin capitalization provisions are generally present in all jurisdictions examined. As a fact there are other measures in effect in some countries (like Belgium). Hereby dividends are treated the same way as interest. In this respect the general idea to solve the disparity between the credit and the exemption methods is to treat debt financing the same as equity financing. That way companies will not be tempted to opt for transforming equity into debt solely because of favourable treatment.
In an international environment some measures for improving neutrality conflict with the tax and fiscal sovereignty of taxing jurisdictions. In ordering specific treatment for passive source income interferes with countries’ sovereignty in the field of direct taxation. The certainty of breached of the principle sovereignty simply depends on the method or institution obliging countries to offset imbalances between interest and dividend payments.

In order to apply the same treatment to interest as dividends, or imposing limitations on interest deductibility, many countries - especially in the EU - face problems of sovereignty.

All the Eucotax countries do have constitutional references to accept the binding nature of community law in the EU (except, of course, for Switzerland and the US) and soft law. As a result some proposals of a supreme body would all have to through the lawmaking bodies of individual countries.

Nevertheless the implementation (of either of the two methods that offset the disparity between the worldwide and source taxation principles) is generally effective only if it is applied on a broad scale. This is the way like otherwise double taxation might occur. As a result the idea of improving neutrality might also have implications for the rule of law. In the past it is often argued that if only certain countries apply these methods, this will cause problems as regards the rule of law. Likewise because delegating taxing jurisdiction power to a state on the one hand without the certainty of being granted the same means loss of jurisdiction on the other hand, and in turn a dent in sovereignty.

5.4 Conclusion
The source principle might represent the best jurisdictional connection. This because it provides an equitable distribution of taxing claims between countries involved in international transactions. This all should be linked with the principle of sovereignty and with the ideas of equity among nations.

But the source principle is doubtly in line with the principle of ability to pay. In addition, this is also the case with the idea of equity among individuals. This has to do with the fact that some companies could make billions of profits abroad, but this will not affect the source state taxation in a country which is based on a source principle.

Finally bonafide companies that operate abroad but have their losses in the territory of its residence will be treated like a company which is in a really bad economic and financial situation in the state of source.
The application of worldwide income taxation is in line with the idea of horizontal equity among individuals. As a result the country of residence must take into consideration the: global amount of profits generated by companies, this in order to tax according to their real financial capacities. Furthermore the incompatibility with the ability to pay can’t defend the non-application of a source-based tax system. At the moment we are only dealing with corporation tax which is not compatible with the ability to pay principle even at a national level because of the frequent application of flat tax rates.

The general principle may not explain the implementation of a global system of taxation. Also this may just serve as a way for countries (specially the most developed ones) to protect their tax base. The protection is needed from the competition of tax havens including low-or zero- tax jurisdictions. It should be noted that in practice no tax system fully serves the worldwide or source-based ideas. This is also the case with the effect of unilateral or bilateral provisions aimed at mitigating the risk of double taxation and distortion caused to the private sector by the tax system (i.e. tax credit and exemption).

The conclusion of our subgroup during the EUCOTAX Wintercourse week was that the development from national towards global tax systems should be done primarily on the basis of principles, under the supervision of a supranational body. Thus all of our systems are actually largely based on the wrong principles. This results in problems like double taxation (which might be a little outdated) and double non-taxation (which might be more actual), thus faced in all of our countries. Aggressive tax planning is the major driver behind these problems (e.g.) while making benefit of tax competition, also a concept aroused from the non-coordination of states on the international tax law.

As a result states react with correction mechanisms, solely based on rules (like e.g. indirect credit or participation exemption regimes with respect to inter-corporate dividend streams, tax consolidation regimes for groups of companies and anti-abuse measures such as intra-group interest deduction limitations seeking to counter profit shifting to low tax jurisdictions though intra group debt financing arrangements). All of these mechanisms are reactions on the failure to capture the economic reality, as the allocation determined accordingly does not respond with it.

Debate on these rules was in my opinion irrelevant, as the system is sick from the inside (principles). It should be noted that this was the common opinion in our subgroup. Therefore we didn’t put a lot

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481 Wilde de, M.F., *Some Thoughts on a Fair Allocation of Corporate Tax In a Globalizing Economy*, Intertax, Volume 38, Issue 5, 2010, p. 282. Examples of anti-abuse measures are subject to tax clauses, ‘switch over’s’ from exemption to ordinary credit with respect to foreign low taxed passive income, controlled foreign company (CFC-) legislation, and interest deduction limitations. The decision to keep the activities in-house is based on economic considerations (the theory of the firm). This reality is ignored under the arm’s length principle.
of effort in these discussions. What the above mentioned debate underlines is that also recent proposals of the EC considering financial transaction taxes are also examples of failures. Even the success in persuading tax havens to sign information agreements could be dismissed as the sort of hollow victory one must expect when dealing with rogue states.

Thus the outside (rules) will change every year, if not month, and always this will be a reaction on developments on the tax advisors. This circle is viscous; thus a never-ending story.

To say it striking: ‘transnational enterprises remain square pegs to the round holes presented by national corporate taxes’. 482

6. Preferable principles in the light of aggressive tax planning

The previous sections described the different principles in the field of international taxation. As mentioned before, the world of international tax law is a heavily debated area. Some authors defend that ‘the international tax regime’ exists, whilst others are strongly against this opinion.

Hart e.g. expressed the paradox of international law, since in his opinion it is offering grounds for both optimism and pessimism: on the one hand, “the absence of an international legislature, courts with compulsory jurisdiction, and centrally organized sanctions” does not necessarily imply that international law cannot exist. However on the other hand, he suggest that designing a principle (what he described as ‘a basic rule of recognition’) sufficient to assuage “doubts about the legal ‘quality’ of international law” would be tantamount to catching lightning in a bottle. The correlation with international tax law is founded herein, that this field of law exactly demonstrates the ‘truth of both perspectives’. The basis is that a World Tax Organization omits. The ‘international tax regime’ claims to be the bunch of treaties and laws, whose aim is to form a response to primarily double-taxation. In other words, these treaties form a ‘coherent international tax regime’ that enjoys nearly universal support. As a result, what should be ‘an extractable problem’, i.e. allocating global tax revenues among sovereign states, has been anything but. The international tax regime could be described as a ‘flawed miracle’.

However it may be doubted on the other hand of ‘the international tax regime’ exists. Since there’s not an international field of organization this probably is not the case. However this is not inside the scope of this research.

6.1 First level: principles of fairness and equality in international context

The benchmark of this research is aggressive tax planning. Already in the introduction there are some examples mentioned of the problems resulting from this ‘type of engineering’. However, one may question whether or not this ‘engineering’ is in conflict with the principle of justice, since MNEs (and

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everyone else) are free to arrange their business affairs in such way in order to keep the tax burden low. As shown in the following figure, in recent decades the distribution of disposable incomes tended to be less equal. The example makes this clear: the so-called Gini coefficient (whereby 0 is perfectly equal, and the higher the coefficient the less equal the distribution) in the mid-1980s stood at 0.28 among the working-age population, while by the mid-200s this has raised to 0.31. Supporting an equitable income distribution is one of the key goals of fiscal policy.\(^{490}\) Tax policy can play a role in making the post-tax income distribution less equal. Since taxation is crucial for raising revenues to finance public expenditure as well on growth-enabling infrastructure that can increase social equity. Aggressive tax planning definitely influences this trend not in the right way. It probably makes it worse. The need to tackle aggressive tax planning can easily made clear via the following figure:

As a result, the effects of taxation on income distribution need to be seen in the context of the trade-offs between growth and equity, as the entire system as a whole.\(^{491}\) This goal could be achieved via both direct and indirect taxes. The latter fall on the consumption of goods and services; this is often regressive if this make up a larger share of the budgets of poorer than richer households. However the overall impact of the reform can also be progressive, if these effects are offset by other tax and benefit changes. Income related benefits are much more efficient way of increasing the disposable

\(^{490}\) OECD, *Current Tax Agenda 2012*, p. 36.
\(^{491}\) Ibid. at 37.
income of poorer households than reduced rates of VAT. But in the case of developing economies on the other hand, the relatively greater reliance on indirect taxes could make their tax systems more regressive. Consumption taxes may be the only way to finance strongly progressive sending. Although some countries lack the administrative capacity to make welfare transfers to household, there may be a case for differentiating VAT rate structure to tax ‘necessities’ at a lower rate.

The most fundamental legal principle (international) is considered to be the principle of justice. This principle requires that it should be irrelevant for corporate tax purposes where the economic operator has his place of residence. Although this sounds touching, it should be noted that in practice the current regime of allocation is not based on any real agreement between and thus cannot be rationalized by any ‘obvious principle of justice’. The principle of justice is achieved by another fundamental legal principle: the principle of equality. This would require that it is also immaterial whether or not the economic operator performs it business activities in a cross-border context. Next to this, eliminating all the obstacles in international tax systems requires removing of all inequalities in tax treatment between resident and non-resident taxpayers.

6.2 Second level: equity and efficiency
With respect to justice, this principle is in practice used for two different interchangeable concepts, i.e. equity and efficiency. Equity is even often applied mutatis mutandis for equality. Efficiency on the other hand is also founded on the principle of equality. Corporations should be taxed equally; otherwise this would lead to distortions in the efficient allocation of production factors. Again, this means that the ability to pay principle and the benefit principle result from that.

Tax equity can be divided into inter-nations and inter-individual equity. The latter is not relevant for this thesis, while the first exactly points the current discussion on the jurisdiction to tax in international tax law. Inter-nations equity is therefore relevant in this discussion. The principle of inter-nations equity could be the practical appearance of the principle of justice.

With respect to the above mentioned maximization of efficiency, the common sense is that tax efficiency is in practice achieved by the economic principle of neutrality. Therefore it is generally assumed that besides tax motives, also economic motives should be the basis for allocating production factors. However some authors argue that equity should also be part of the concept of international tax neutrality, not only tax efficiency. This would imply that tax efficiency could not be used mutatis mutandis for tax neutrality. This would probably affect the previously mentioned inter-nations equity discussion.
Efficiency aspects, more particular the avoidance of distortions (and excess burdens), are the main concerns that dominates the debate among scholars of public finance in the discussion on the optimal tax theory.\textsuperscript{492} In general this theory connects neutrality with distortion. According to this theory, no existing can be considered to be fully neutral to the market mechanism, regardless of whether the tax is indirect (VAT) or direct. Hypothetically this can be achieved by lump-sum tax, but that has been rather a theoretical concept. This lump-sum tax would be collected from all taxpayers in the same amount thus it would not cause changes in their behaviour.

In the field of direct taxation it is possible to invoke the principle of tax neutrality in cases of violation, \textit{i.e.} as the discrimination between the different categories of operations or economic agents is rather obvious. Some authors claim that under the VAT this role of neutrality is different, since the application of the principle of tax neutrality involves an approach at a different level, that of the fiscal procedures. In most cases the necessary elements for the identification of tax measures that generate e discrimination between different categories of investors and economic operators is difficult.\textsuperscript{493}

With respect to neutrality, states that make use of worldwide taxation, taxes the domestic and foreign income of its residents, based on the economic concept of CLEN. The territorial method limits the jurisdiction of a state to the income derived in their boundaries by both residents and non-residents. Economically these territorial systems are based on the concept of CLIN. In practice both system are applied parallel to each other with possible deviations and varieties of approaches.

In general, CLEN requires a system for worldwide taxation plus foreign tax credit. The investor should pay the same total tax; irrespective of the given investment income is derived for foreign or domestic sources. The same rules should apply to both sources, by allowing the same investment credits and accelerate depreciation for foreign and domestic investment. CLIN implies that capital funds originating from various countries should compete at equal terms in the capital market of any country.


It is a fact that complete neutrality cannot be achieved in practice, however it is often defended the principle of CLEN fails to achieve complete neutrality but also negatively affect the competitiveness. It is also often defended that the globalization requires a tax policy that allows companies to compete at equal terms in a respective market. Businesses do compete with each others, not owners. This can be achieved by CLIN plus the application of a source-based taxation. Since residence-based taxation is based on the residence principle. This should counter both for direct as for portfolio investments. Although the term ‘source-based’ or ‘source’ is not always interpreted correctly. Therefore Kemmeren suggests an origin-based interpretation of the term source.

As an alternative to CLEN an CLIN, Vogel introduces the concept of ‘inter-nations neutrality’. This would serve when states do not employ their sovereign taxing powers to influence the prices in other states. The tax burden should be the same as any other who, in similar circumstances and to the same extent, utilizes the public goods provided by that state. This can be extracted from the benefit principle. De Wilde criticised this notion this would be similar to CLIN and therefore the ability to pay principle would omit. He prefers the situation that occurs if a state exercises its sovereign taxing powers and subject an economic operator to tax, the tax burden should be equal; irrespective of the taxpayer’s place of residence or effective management (benefit principle). The author plea for a combination of the best elements of both systems.

This could be a interesting approach, since I do agree with Burgers that one should not dragged through the old idea that a tax system must ensure either CLEN or CLIN. It is not a way of adopting purely one method; it shall always result in a combination of both. This corresponds to the aforementioned determination that international tax literature is (too) often focussed on efficiency (and welfare) maximization. In addition, the globalization has blurred the classical distinction between capital-exporting and capital-importing countries. In the proposal of de Wilde, CLEN will provide the element of ‘worldwide taxation’ in order to serve the principle of ability to pay, while the CLIN concept provides the element of economic presence to serve the benefit principle.

**Single tax principle**

There seems to me little discussion on the fact that the single tax principle is evident in international tax law. This is derived from the principle of equity. The single tax principle requires that income from cross-border transaction should be subject to tax once. The appropriate rate of tax for purposes is then determined by the benefit principle, which assigns the primary right to tax active
business income to source jurisdictions and the primary right to tax passive income to residence jurisdictions.\textsuperscript{494}

De Wilde proposes to add a new element to this list: ‘Capital Neutrality’.\textsuperscript{495} This would require a jurisdiction to impose worldwide taxation on the income of its residents, which can be extracted from the CEN concept. However, this should be enriched with worldwide taxation of non-residents that meet a minimum threshold of economic presence, in order to avoid non-discrimination. An example could be a permanent establishment. The relief of double taxation is, in order to satisfy the single tax principle, given via a Dutch method called the ‘tax exemption method’, which he sees as an combination of CEN and CIN. In his view CEN discriminates multinationals (opposed to domestic corporations) to the extent that the residence country does not fully credit source-country taxes. This is in his view a clear example of violation of the benefit principle of international tax law, which links tax liability with public goods received. In contrast CIN violates the ability to pay principle, which links tax liability with public goods received, since it discriminates by taxing source-country income without reference to losses incurred in non-source country jurisdictions.\textsuperscript{496}

From a historic point of view the credit method was a tool for combating tax avoidance. However, nowadays it is out of date in this regard, as the exemption method with a subject-to-tax clause can also combat this without the necessity of a disadvantageous additional tax levy on the part of the state of residence.\textsuperscript{497} With respect to tax-avoidance, CFC legislation is relevant, as being one of the most important anti-avoidance measures. This legislation was seen to be justified to achieve CLEN.\textsuperscript{498} Via CFC legislation states attempt to prevent deferral of taxation or non-taxation that the taxpayer has tried to produce by placing sources of income in a foreign company located in a country with a low tax burden. CFC legislation try to prevent this by actually ignoring the legal entity’s independent tax liability in the other state. The foreign company’s income is taken into account in the hands of the resident taxpayer.

In the light of anti-avoidance, it is clear that under CLEN double non-taxation will not occur, due to the fact that whenever an item will not be taxed in the state of origin it will be taxed in the state of

\begin{footnotesize}
\begin{itemize}
\item \textsuperscript{494} Avi-Yonah, R.S., \textit{Tax Competition, Tax Arbitrage and the International Tax Regime}, Bulletin for International Taxation, April 2007, p. 133.
\item \textsuperscript{495} Wilde de, M.F., \textit{Some Thoughts on a Fair Allocation of Corporate Tax In a Globalizing Economy}, Intertax, Volume 38, Issue 5, 2010.
\item \textsuperscript{496} \textit{Ibid.}
\item \textsuperscript{498} Weber, D.M., \textit{supra} note at 121, with references at 160.
\end{itemize}
\end{footnotesize}
residence. However with respect to direct investment either argues that CLEN is necessary to achieve the prevention from this shift of investment capital to low-tax jurisdictions cannot be advocated, since the overall general policy of states is to conclude tax conventions with these states.\textsuperscript{499} Besides this fact, in a corporate structure parent companies are eager to shift their legal residence to low-tax states. With respect to income from portfolio-investments, it has been argued that taxation of interest requires the stability of taxation so it does not change the market conditions subject to which the debtor operates. Herein a CLEN based system might be more effective to prevent fraud.\textsuperscript{500}

6.3 Third level: ability to pay and benefit principle

The principles of ability to pay and benefit are used in the sense of underlying principles for allocating tax jurisdiction.\textsuperscript{501}

Ability to pay

The ability to pay shall always be taken into account, but previous sections has shown that in international context is depends on the context to what extent this shall be adhered. For the different context the other sections thus provide clearance.

Benefit

The benefit principle will be highlighted more in detail, instead of the principle of ability to pay. When Hart was looking for a catalyst that could transform an assemblage of international tax rules into a vital system of laws, he might be not thinking of the benefit principle. However, the success and stability of the international tax regime over nearly a century suggests that it comes close.\textsuperscript{502} Although this deemed ‘success’ is appreciated, this benefit principle has not helped the regime evolve over time.\textsuperscript{503}

Due to the globalization, this concept is also under pressure.\textsuperscript{504} Clear example are the MNE’s who shifting their income to low-tax jurisdictions on the one hand, while still benefit from the jurisdictions where the business is headquartered. Some authors argue that the benefit principle does not

\textsuperscript{499} Kemmeren, E.C.C.M., supra note 17, at 113.
\textsuperscript{500} Ibid. at 114.
\textsuperscript{501} In similar way: Kemmeren, E.C.C.M., Source of Income in Globalizing Economies: Overview of the Issues and a Plea for an Origin-Based Approach, Bulletin for International Taxation, November 2006, p. 431. Who states that: ‘it should be noted that the (direct) benefit principle is used here merely as an underlying principle for allocating tax jurisdiction among states’.
\textsuperscript{502} Dean, supra note .. at 538.
\textsuperscript{504} Graetz. M.J., Taxing International Income: Inadequate Principles, Outdated Concepts, and Unsatisfactory Policies, 26 Brook. J. International Law, 2001, p. 1417 (e.g. e-commerce, derivates, e-money and tax havens as part of the new reality that challenges the capacity of the international tax regime).
encourage states to cooperate by investing in extraterritorial enforcement assistance.\textsuperscript{505} In addition, the authors state that the benefit principle tells state what share of global tax revenues they may collect but not what they should (and should not) do to help them enforce their taxes.\textsuperscript{506} Dean pleas for a combination of the benefit and the (what he called) burden principle. This would, in simplest terms, ‘reward states for their effort to combat failures such as corporate income shifting and individual tax evasion’.\textsuperscript{507} In addition to the current treaties, which allocate tax jurisdiction solely according the residence or source principle, this combined principle will introduce a compliance element.

6.4 Fourth level: quantitative legal principles
The 65th Congress of the International Fiscal Association (hereinafter: IFA) was held in Paris on 13 September 2011. The topic of subject two of this Congress was entitled ‘Key practical issues to eliminate double taxation of business income’. This considered among others the practical difficulties encountered in both worldwide tax systems and territorial tax systems. The relevant context was the elimination of double taxation of business income.

This Congress which traditionally results in a book (\textit{Cahiers de droit fiscal international}) provided valuable insights for the topics discussed in this research. Thus this book, which contains branch reports of all ‘relevant’ countries in the world, is primarily used for the evaluation.

Also it should enhance the equal treatment of business as they don’t have to pay the aforementioned possible tax difference between the source and the residence state. The disadvantage is that it encourages the shifting of investments and activities to low-tax or tax haven countries and requires anti-deferral rules to prevent residents from engaging in these activities.\textsuperscript{508}

Although there are several advantages from equity and efficiency perspective claimed for the territorial tax systems, with respect to aggressive tax planning they are more sensitive than worldwide tax systems.

Conclusion
it remains that the exemption treatment is simpler than an equivalent indirect credit, even in a sophisticated legal environment. Typically, this is clearly far less complex to exempt non-portfolio dividends than to tax such dividends with an underlying tax credit for taxes paid by the distributing

\begin{itemize}
\item \textsuperscript{505} Kemmeren, E.C.C.M, \textit{supra} note 17, at 571.
\item \textsuperscript{506} \textit{Ibid.}, at 572.
\item \textsuperscript{507} \textit{Ibid.}, at 577.
\end{itemize}
company and possibly its own subsidiaries. Exempting the income avoids a computation of the foreign distributed income in accordance with domestic tax rules; it further avoids making that calculation though multiple tiers of foreign subsidiaries; it also avoids apply per-country and/or per-income limitations when it comes to determining the maximum amount of the imputable credit.

This is not to say that complexity should be avoided as a matter of principle. Complex rules are legitimate as long as they foster economic neutrality and avoid abusive loss of revenue. However, as pointed out by certain Eucotax colleagues, indirect credit rules distort business decisions and do not prevent the risk of loss of revenue, in particular when applied in combination with deferral rules. This is mainly because, as already mentioned, deferral rules discourage the repatriation of profits earned abroad and work as an incentive to reinvest cash offshore. By operating as a sort of antidote for the convoluted indirect credit rules, the deferral mechanism generates tax-distorted decisions and yields results which may actually be more detrimental to state revenues than the results deriving from the exemption system.

In the light of overall dissatisfaction with the indirect credit principle, it is no surprise that many credit countries, including developing countries, have considered and in certain cases implemented fundamental changes in their credit rules, a repeal of the deferral rules or even a radical shift to exemption, at least for non-portfolio dividends.
6.5 Fifth level: qualitative legal principles

The aforementioned geographically restricted principle of sovereignty entails in a globalized world that corporate income from cross-border activities should not only be allocated among taxpayers, but also between states. This allocation methodology currently applied seeks to capture the economic presence and to localize geographically the value added in order to place it within the territory of state that may subsequently tax it. In the field of direct taxation this is primarily done via the allocation principles of residence and source. In contrast, the indirect taxation method makes primarily use of the principles of origin and destination. These qualitative allocation principles are based on the more quantitative allocation principles of universality and territoriality. It should be noted that the principle of neutrality connects both fields of taxation.

The allocation of tax jurisdiction with respect to income is traditionally based on the principles of residence and source. Decisive for the acknowledgment of the qualitative legal principles is thus the real situation. The personal qualitative legal principles of nationality and residence do not produce income, thus making them more sensitive for tax avoidance, as the real economic situation is not served. The principle of residence is considered to be far away from the personal allegiance, but closer to economic allegiance.

Nationality

Nationality is considered to be one of the most sensitive principles for aggressive tax planning, thus this will not be discussed further.

Residence

Supporters of residence as the primary jurisdictional principle point the benefits of CLEN plus the fact that this will promote horizontal equity since it allows the effective imposition of progressive taxes, whereby the principle of ability requires that persons with more income are more taxed.

Some authors argue that since income is merely a characteristic of persons, the most appropriate justification for imposing tax on the income must therefore be based on residence.


In particular, residence country taxation is sensitive for aggressive tax planning since the residence can easily be manipulated. Other example of this weakness is the interposing of artificial entities which establish their residence in a place that is equally un-meaningful for the purposes of justifying a jurisdiction to tax. Applications of the residence principle offer opportunities for tax planning while triggering reactions (rules) e.g. limitation on benefits provisions. This would violate the administrative efficiency, thus an example of the benefits of a principle-based approach. This principle will further be act as an incentive to re-locate headquarters to low-tax countries.

In addition, taxing the corporate income in the hands of the parent company is still more or like the same as source-based taxation, since the location of the parent is not fixed thus sensitive for aggressive tax planning. True-based residence taxation would have to be at the level of the individual investor, which is a globalised world quite infeasible. 

Source

The deemed advantages of the source country taxation is that is said to be justified by the benefit principle or under a wider concept of economic allegiance, which would favour ‘an equitable distribution of taxing claims between countries [of the] income generated by international transactions’. Any response to non-taxation issues that has the effect of increasing the allocation of taxing rights to the residence country must presumably be seen as tending to decrease international equity. However the connecting factors of the source-doctrine, statutory source rules and the common law ‘facts and circumstances’ doctrine, date from an ancient history. In a globalized world the question is: where is the source? It is difficult to determine where the activity effectively has been carried out. Therefore the question is whether traditional source-based allocation rules are still appropriate for the current century. For the problem of e-commerce Pinto suggested a source-

513 Atchabahian and Schindel, *pp. 29-30*
519 A question asked by Vogel, Part I, p. 223.
based allocation of taxing rights, but the way in which source is defined needed to be reconfigured.\(^{521}\)

### 6.6 Indirect taxation

In direct taxation the principles underlying the jurisdiction to impose taxes in direct taxation are the source and residence principle. Under VAT these principle are the origin and destination principle. In this respect, the origin principle is logically analogous to source-country taxation. The destination principle appears at least at first sight, to be logically analogous to residence-country taxation. Several scholars draw this comparison between source and residence principle, on the one hand, and the origin and destination principle, on the other.\(^{522}\) Despite the frequency of this comparison, it seems to be of little significance for three reasons.\(^{523}\)

### Origin

The origin principle is currently only applicable in the field of indirect taxation. In this respect, it is not very popular. Millar named the weakness of the origin principle as the first argument. Overwhelming international consensus exist that the destination principle should be used. Therefore Bird an Genron note that one of the key areas in which all VATs are fundamentally similar is their support for the destination principle.\(^{524}\) However Kemmeren suggested this principle as the new connection element, as a replacement of the traditional source criterion.\(^{525}\) With respect to allocating rights, the primarily rule should be the place where the income originally has generated, i.e. where the intellectual element is to be found, or a substantial income-producing activity is carried on.\(^{526}\)

### Destination

Avi-Yonah amongst other mentioned the popularity of the destination principle in the VAT.\(^{527}\) In particular the fact that such taxes are imposed on a destination basis without the need for a

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coordinating tax treaty.\textsuperscript{528} Therefore he suggested that the OECD should adopt a regime that taxes MNEs as an ‘initial mater in the country of consumption of the goods or services provided by the multinational’\textsuperscript{529}.

As Auerbach et al concludes, the point of sale is the one in the production chain which is the most easily identifiable, and harder to manipulate. Therefore the taxation of corporate profits should take place at this point under a destination-based tax. Thus a business income tax based on cash flows, \textit{i.e.} the destination-based cash flow tax.\textsuperscript{530} Such a tax would link up with goods supplied and services rendered by economic operators. It would basically function as a VAT system, on a cash basis, with a deduction for wages (labour costs). It would tax imports, but refund exports. The authors consider this principle will lower the opportunity for companies to shift profits between countries, thus making this principle less sensitive for aggressive tax planning. Indeed this principle seems to have the characteristic that there would no incentive to shift profits to low tax-rate jurisdictions.

\textbf{6.7 Institutional issues}

From the research on principles one extracts the fact that the world (or at least Europe) strives for a new system, based on the correct principles. These principles might be the ones discussed in this research. Ideally, the system or organization should serve the entire world, since the 2008 financial and economic crisis fiscal sustainability emerged as a central goal worldwide. The authors caution that ‘integration of standards into binding agreements is necessary to translate ‘governance into law’.\textsuperscript{531} One must question how exactly this coordination and policy development takes place within and among organizations? The major players are the G-20, the OECD, the UN, the IMF, and the WTO. The first considered to profile itself as ‘a high-level deliberate forum that invigorates tax initiatives of other international institutions’ but since it lacks of institutional capabilities to elaborate and implement politics, it is depending on the other fora.\textsuperscript{532} In particular the OECD seems to be very connected to the G-20, while the IMF appears to be ‘less effective’. The authors conclude that only the UN is active in the field of tax policy making. However, the UN lacks capability too. The WTO is considered to have the most ‘far-reaching oversight of national tax policy’, since the SCM Agreement

\begin{flushleft}
\textsuperscript{528} \textit{Ibid.}\textsuperscript{529} \\
\textsuperscript{529} \textit{Ibid.} \\
\textsuperscript{532} \textit{Ibid.}, at 29.
\end{flushleft}
covers some taxes who that are covered by the definition of a subsidy. Wouters and Meuwissen conclude that ‘no single international forum can be accepted as a fully effective and legitimate global policy-maker’. Most implementing of the initiatives are left to the free will of states, while the organizations only focus on the delivering of advise and the monitoring of both national and international trends. The international judicial oversight of national taxation remains exceptional, since it is still strongly adhered to the principle of sovereignty (national).

Thus a European approach would be more realistic. On a European level, the authority could be the European Council, the European Commission or the ECB (as a backup to the European Monetary Fund). Vanistendael concluded that all of them are unsuitable for this task. In addition, in times of crisis the Member States are faced with a dilemma: either leave sovereignty to the intentional financial market (or the IMF) or to transfer their sovereignty in a systematic and preordained way to an ‘Euro-land authority’. To conclude: both on an international and a European level there’s lack of an effective forum.

A quotation describes the current situation as “governance has three states, like mass. The national which is solid, the European which is liquid, and the international which is gaseous”. (Pascal Lamy, fifth Director-General of the WTO)

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533 Ibid. However, given the great diversity in tax culture between the different countries involved in the WTO it is perhaps more realistic to operate on a European level.
536 Ibid.
Chapter 7: Conclusions and recommendations

7.1 Conclusion

‘Principles and Standards of Transnational Taxation’ was the subject of the first topic of the Wintercouse 2012 in Lodz, Poland.

The recent attention to tax behaviour of both MNEs (e.g. Apple, Wall-Mart) and High Net Worth Individuals\(^{538}\) (e.g. Bono) is tremendous. Tax avoidance by MNEs is about exploiting loopholes through aggressive tax planning, which is in principle considered to be legal. However this might be morally challenged, in contrast to tax evasion, which is barely engaged by MNEs. These MNEs may deserve social opprobrium if they bend tax laws, but the governments should provide answers and solutions for it.

The international (or: transnational) tax regime could be described as a combination of both an optimistic and pessimistic perspective, but probably does not exist. On the one hand it functions based on treaties and laws, since a World Tax Organization omits, while on the other hand there’s a lack of future perspective, \textit{i.e.} evolving. Question arises if this is a problem? The continuing mismatch between demands made of the international tax regime and its capacity has rendered it impotent in the face of today’s challenges. The combination of a globalizing economy and the geographically restricted fiscal sovereignty of states lead to problems (influence of international tax systems on the behaviour of MNEs) in the allocation of tax among tax payers and between states. This is not surprisingly, as the allocation principles are based on the 1920s compromise. It is clear that the evolving problem does not directly imply that there’s a need of an international tax regime. However, it does imply that at least the current tax systems should be based on the same principles.

The approach by the several institutions to replace the standards of the international tax regime by rules can be characterized as a struggle that will only continue, if not accelerate, that failure. Despite a proposal like the CCCTB, in the field of allocating jurisdiction (with respect to aggressive tax planning) the only solution tends to be on the precision of rules. Scholars on the other hand deliver several opinions from what can be concluded that, besides there’s no shortage of problems, nor shortage of proposed remedies. Current treaties based on the residence principle necessitated source-based corrective actions such as LOB-provisions.

It can be stated that it is urgent to close the growing gap between the architecture of the international tax regime and its basic norm. This is hardly possible since those rules rely on principles that were designed to solve the quaintly outdated problem of double taxation.

Cynics may therefore dismiss the progress of the OECD with respect to e.g. tax havens (to sign information exchange agreements) as the sort of hollow victory one must expect when dealing with rogue states.

The focus of this research was on international corporate business income derived by MNEs, not surprisingly the main subject of several papers and communications of international organizations. In this research different principles have been evaluated in this context. Laws that govern our behaviour draw strength from principles that operate unseen in the background.

**Indirect taxation**

The aforementioned neutrality concept functions as a bridge between direct and indirect taxation. In direct taxation the principles underlying the jurisdiction to impose taxes in direct taxation are the source and residence principle. Under VAT these principle are the origin and destination principle. In this respect, the origin principle is logically analogous to source-country taxation. The destination principle appears at least at first sight, to be logically analogous to residence-country taxation. Several scholars draw this comparison between source and residence principle, on the one hand, and the origin and destination principle, on the other.\(^{539}\) Despite the frequency of this comparison, it seems to be of little significance for three reasons.\(^{540}\)

At first the ‘origin principle is not a significant contender’, since it is generally accepted that the destination principle should be used. The use of the origin principle in VAT is primarily due to the fact that the harmonization process of VAT is not completed yet.\(^{541}\)

Secondly the origin taxation of supplies is equivalent to resident taxation of supplier’s income.\(^{542}\)

From the point of view of the tax payer, the origin principle is in fact analogous to residence rather than source. On international levels, the taxation of consumption on a source basis (i.e. at origin) is equivalent to taxing the income of suppliers on a residence basis. In contrast, in the view of the

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supplier the principle of origin is more akin to residence taxation of income. This is another argument against origin-based taxation of consumption. If the arguments in favour of source country taxation of income on the basis of inter-nation equity ‘have any merit, then they must be equally applicable to consumption tax; and since taxing consumption is equivalent to taxing the income of suppliers on a residence basis, the inter-nation equity arguments should presumably favour taxing consumption on a destination basis’. 543

The last reason is that residence of consumer is not equivalent to destination. For the purposes of VAT, destination means place of consumption and thus not residence of the consumer. The fact that the practical effect of the destination principle often results in taxation of consumption where the consumer is resident, is due to the fact that consumers often consume goods in their country of residence. This has nothing to do with the fact that VAT sues customer residence as the basis for asserting substantive jurisdiction.

Thus one proposal could make sense, that of the Auebach, Devereux and Simpsom. They propose a business income tax based on cash flows, thus to be considered as a destination-based cash flow tax. Such a tax would link up with goods supplied and services rendered by economic operators. It would basically function as a VAT system (on a cash basis) with a deduction for wages.

**Solutions**

Several solutions are proposed to solve the problems regarding international taxation. This thesis is not of the nature that it is able to discuss all of them, thus it mentions some of them (which does not imply that these are of more importance than others). Apart from the proposal out of the ‘VAT-field’, this research identified three different solutions which could be relevant to tackle the problem of aggressive tax planning.

First: the proposal by Kemmeren to adopt a origin-based system, especially for interest payments. If this is implemented, it could be expanded. The prevalence for CLIN is already been clarified. This would imply a source-based approach, however Kemmeren suggest an origin-based interpretation for the term ‘source’.

Second: the proposal of de Wilde, who suggest a combination of what he called internal equity/capital neutrality plus the credit for domestic tax attributable to foreign income. This would leads to a system of unlimited tax liability within a taxing jurisdiction which arises as soon as the

543 *Ibid*, at 284.
The economic operator is economically present within that jurisdiction. The taxpayer is taxed for his worldwide income, irrespective of its place of residence. Hence sovereignty as the single-tax principle are respected by applying double tax relief with respect to the foreign income through the credit. Abuse may be countered with a subject to tax clause in combination with a switch over to the common ordinary credit method. This idea is based on the single entity taxpayer, operating its foreign business through branches. This so called separate entity approach (each separate group company is considered as a single taxpayer) needs to be let go in favour of a unitary business approach, e.g. global tax consolidation or a ‘look through’ mechanism. The MNE should be treated as the taxable unit. This would require a worldwide taxation system, thus based on the principle of universality. An example could be the global corporate tax base for business income combined with a tax consolidation regime. An allocation key on the basis of economic presence should divide the tax bases between the respective tax jurisdictions. Examples of this allocation key could a ‘global formulary apportionment’ or the ‘significant people functions’. This should result in an equal tax liability, i.e. effective tax rate, for the corporation. More important, it would be irrelevant where the business activities are performed. This would in first instance satisfy at least the neutrality principle, as distortions no longer exist. On a European level the CCCTB project is quite similar.

Of great importance in this respect is ‘to capture economic reality’, exactly that thing that the 1920s compromise fails.

Third: the proposal of Dean, who suggest a benefit-burden principle. Especially in the context of aggressive tax planning this make sense via the secure mechanism. The benefit principle is out of date, but still supported by the most authorative scholars (among others Avi-Yonah and Kemmeren). The addition of a extra mechanism makes thus sense.

Besides the four proposals, transfer pricing might also a field which require attention. The existence of e.g. tax havens, tax competition, and corporate expatriations would be primarily due to transfer pricing. Again, a system that could reflect the economic reality would largely solve these problems.

The origin-based principle or interpretation of the source concept is primarily based on the reflection of the economic reality. This ‘economic reality’ thus seems to be a key-concept in identifying the principles which could be relevant for a future global tax system. This is merely the same idea of other authorative scholars, who propose respectively e.g. the direct benefit principle (Kemmeren),

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benefit-burden principle (Dean) and the economic allegiance principle (Kemmeren and De Wilde). Thus these ‘economic reality’ concepts are considered to be the key-concepts who reflect the less sensitive structures for aggressive tax planning. This seems valid to me, since the abusive practices of aggressive tax planning often involves artificial constructors that do not reflect the economic reality.

Thus these concepts need further clarification which is beyond the scope of this research. However, this research is valid enough to state that these ideas are of the right nature.

**Preferable principles**

With respect to considerations of equity, other principles should also be taken into account for a future global tax system. The single tax principle (Avi-Yonah) is commonly accepted as being one of these. This is often linked with the universality principle which appears in worldwide tax systems. This is then combined with exemption method (De Wilde).

From the indirect taxation the destination principle (indirect tax) can be derived. These elements might replace the principles underlying the current international tax systems: *i.e.* residence principle, source principle, personal allegiance principle, territoriality system, credit method.

**EUCOTAX comparison**

The conclusion of our subgroup during the EUCOTAX Wintercourse week was that the development from national towards global tax systems should be done primarily on the basis of principles, under the supervision of a supranational body. Thus all of our systems are actually largely based on the wrong principles. This results in problems like double taxation (which might be a little outdated) and double non-taxation (which might be more actual), thus faced in all of our countries. Aggressive tax planning is the major driver behind these problems (*e.g.* ) while making benefit of tax competition, also a concept aroused from the non-coordination of states on the international tax law.

As a result states react with correction mechanisms, solely based on rules (*like* *e.g.* indirect credit or participation exemption regimes with respect to inter-corporate dividend streams, tax consolidation regimes for groups of companies and anti-abuse measures such as intra-group interest deduction limitations seeking to counter profit shifting to low tax jurisdictions though intra group debt financing arrangements). All of these mechanisms are reactions on the failure to capture the economic reality, as the allocation determined accordingly does not respond with it.

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545 Wilde de, M.F., *Some Thoughts on a Fair Allocation of Corporate Tax In a Globalizing Economy*, Intertax, Volume 38, Issue 5, 2010, p. 282. Examples of anti-abuse measures are subject to tax clauses, ‘switch over’s’ from exemption to ordinary credit with respect to foreign low taxed passive income, controlled foreign company
Debate on these rules was in my opinion irrelevant, as the system is sick from the inside (principles). It should be noted that this was the common opinion in our subgroup. Therefore we didn’t put a lot of effort in these discussions. What the above mentioned debate underlines is that also recent proposals of the EC considering financial transaction taxes are also examples of failures. Even the success in persuading tax havens to sign information agreements could be dismissed as the sort of hollow victory one must expect when dealing with rogue states. Thus the outside (rules) will change every year, if not month, and always this will be a reaction on developments on the tax advisors. This circle is viscous; thus a never-ending story. To say it striking: ‘transnational enterprises remain square pegs to the round holes presented by national corporate taxes’.546

Conclusion

This part has indicated that there are lots of opinions on the current issue of double non-taxation in international tax law. Some authors defend the global tax system, while others defend that the international tax arena can function via national tax systems. This discussion is not the aim of this research, but I think that the second option can be suitable enough, when the same principles are applied. Thus principles are considered to be a way to solve this problem. Some principles tend to be more sensitive for supporting double non-taxation than others, although principles are always relative and there is no such way as the ‘best way’. It is always a consideration of principles. Hence this will not solve the problem of aggressive tax planning.

Still aggressive tax planning is considered to be legal. To come to an answer for this problem, this research mentions a different point of view, as an answer to the current problem is difficult to find. Therefore a different perspective is chosen, i.e. a more ethical point of view which will be set out in the following section.

7.2 Different perspective: considerations of ethics

This research set out the problem. However, one still may question whether or not taxation has to be ‘the one to blame’. For the answer I choose a different point of view, i.e. a more ethical approach.

Tax planning plays an important role being a very significant cost item for corporations. However, the great accounting scandals led to a major break in this trend. Corporate Governance and Corporate Social Responsibility have become more pressing issues than ever. Thus also corporate social responsibility is getting more attention by years. It is previous defined by the EC as: ‘a concept whereby companies integrate social and environmental concerns in their business operations and in their interaction with their stakeholders on a voluntary basis.’ However, the new definition provided by the EC is: ‘the responsibility of enterprises for their impacts on society’.

This term used to include subjects like child labor and environment policy. Recent developments show that tax policy is hereby more in the picture. As taxes are a way of cutting costs, it used to be far away from ‘corporate social responsibility’. However, there are some voices who claim that this statement is outdated.

The pressure to highlight this on the social responsibility agenda comes from several different groups of the society. For example Non-Governmental Organizations (NGO’s), who claim that corporations has to give transparency on the effective paid taxes in the countries where they are active. The EC, on the other hand, launched a report which is called ‘A Renewed EU Strategy 2011-2014 for Corporate Social Responsibility’ in which it mentioned three principles of good tax governance: transparency, exchange of information and fair tax competition in relations between states. Critical point is, as some authors mention, the discussion is limited to the corporate tax and is not always nuanced. Another critical point is that clearance and certainty about principles like ‘aggressive tax planning’ and ‘fair share’ is absent.

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549 Ibid.
550 See e.g. Eijsden van, A. and Kroneman, R. Belastingstrategie heeft morele dimensie, Financieele Dagblad, 3 May 2012.
551 Organizations like e.g.: Tax Justice Network, ActionAid, Cordaid, Christian Aid and Cafod. Christian Aid recently launched a whole campaign on the issue of taxes in combination with corporate social responsibility: ‘Trace the Tax’.
553 See e.g. Eijsden van, A. and Kroneman, R Belastingstrategie heeft morele dimensie, Financieele Dagblad, 3 May 2012.
554 Ibid.
In the first chapter was mentioned was the fact that aggressive tax planning is in conflict with the spirit of the law. The Dutch Tax and Customs Administration used to have the following commercial sentence: ‘taxes, we can’t make it more pleasant, but we can make it easier’. This is not the approach; this commercial undervalues the fundamental and tremendous value of taxes in our current society.\footnote{Gribnau, J.L.M., Rechtsbetrekkingen en Rechtsbeginselen in het Belastingrecht (diss.), Gouda, Quint, 1998, Stellingen.} To keep a society alive, we can’t go without taxation, to say it another way: ‘nothing of value – not in itself, could go without taxation’.\footnote{Kateb 1992, p.2.}

The success of a market, also and maybe more in times of crisis, dependent on the degree to which the legal system, financed by taxes, provides effective legal protection.\footnote{Ibid.} The modern economic situation can’t resist without taxes.\footnote{Murphy, L. and Nagel, T., The Myth of Ownership, Taxes and Justice, Oxford University Press, 2002, p.8.}

This is closely, if not fully, connected with the society: thus economy is a part of our society. A more philosophic vision could make this more usable. Stiglitz remarks: ‘Every tax system is an expression of a country’s basic values – and it’s politics. It translates into hard cash what might otherwise be simple flown rhetoric’.\footnote{Stiglitz, J., The roaring nineties, W.W. Norton \& Company, New York, 2003, p.177.} This view is taken from the idea that everyone should contribute his fair share for the costs of the society.\footnote{Happé, R.H., Multinationals, Enforcement Covenants and Fair Share, Intertax, 35 (10), p.545.}

As this research focus on multinationals, which tax planning often led to double non-taxation, the question will arise what the above mentioned story has to do with multinationals tax behaviour? It’s quite simply to argue that they have to pay their ‘fair share’. This could be, in terms of taxation, exhausted by Aristotle’s doctrine: ‘a matter of making a properly considered decision about one’s tax behaviour must be in the middle.’\footnote{Ibid. citing: Aristotle, Ethica Nicomachea, 1111 b 5.} This underlines the combat of interests of a multinationals: it’s own interest on the one hand (tax planning) and the interests of the society on the other hand. What is herein practical wisdom?

Importance herein is that this discussion implies that there is a limit to the previous described adage ‘everyone is free to opt for the cheapest solution’ what in practical means aggressive tax planning. This nearly hasn’t got any limits: everything is possible. But is this legal? A philosophic view has the solution: tax planning as being an engineering science finds its limit: membership of a society does not only mean that everyone gets his or her own allotted share\footnote{Ibid, citing: Aristotle, Ethica Nicomachea, V.}, but also that everyone does his or
her own bit. This idea is also well-known from John Rawls. To say it in another way: Shaviro puts it as follows: ‘The management and shareholders should act in the interest of taxpayers generally by confining their pursuit of self-interest in tax minimization to strategies and reporting strategies that are reasonable within the spirit of the law’.

To summarize: the spirit of the rules as well as the social meaning of the law, were gradually lost when it comes to tax planning. This is the consequence of tax legislation as a bunch as a collection of miscellaneous rules which one could draw upon to compile any imaginable device. Thus the paying of ‘fair share’ is one ethic argument. The compliance requirement is considered to be the practical approach to comply with the ‘fair share’ idea.

Tax planning has become a form of engineering. There’s no place for ethical considerations. Question arise how can we see this tax planning in the light of ethics and Aristotle’s middle way? A first observation is that perfect legislation is an unattainable ideal. Already Aristotle remarks in this respect that this isn’t neither the fault of the letter of the law, nor of the legislator; the nature of the case itself, the matter of human action can be simply not understood in general terms. This inadequacy of the law is closely connected with the requirement of generality of the law. Always may situations occurs that are not covered by the word of the Act, but who belongs to be covered in the intention of the law. What does this mean for taxpayers?

Again, Aristotle can have impact: he remarks ‘when the letter of the law thus gives a general requirement and a case occurs that does not fall in the scope of this requirement, it is precisely to repair this shortcoming; one must prescribe what the legislator itself prescribed had if he had been in this situation and what he should adapt in the law if he had known this case’. This quote is about the legislator: he must adapt the law in the spirit of the law.

In this respect the taxpayer should also adapt his behaviour. As Ronald Dworkin said: ‘a reciprocal interplay between law and morals in ordinary practical life, even when no lawsuit is in prospect and each citizen is judge for and of himself’.

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567 Of course there are always mistakes in the law who cannot revail on this fact: compare also, e.g., Geld van der, J.A.G., *Zicht op fiscaal wetgeven*, Tilburg University Press, Tilburg, 1991.
The contribution of fair share of tax can be further operationalized on two levels. On the level of actual devices, wisdom in the name of Aristotelian doctrine requires not only the letter of the law but also the spirit must remain recognizable. The second level is on the level of the effective tax burden: a multinational who is evading that much tax its tax burden is reduced to nearly nil, cannot be viewed as a suitable and sustainable partner for enforcement covenants.\textsuperscript{569}

The discussion about rules versus principles is absolutely not new.\textsuperscript{570} The legal system is built on both principles as rules. According to Dworkin, these two types have to be seen strictly apart, as they have different approaches.\textsuperscript{571} Rules do have an ‘all-or-nothing’ character, or ‘check the box’: they simply apply or don’t apply.\textsuperscript{572}

Principles doesn’t have this character, they just put the weight and propose a reason for a decision.\textsuperscript{573} According to Dworkin this last sentence is fundamental, as it’s the clear relevant distinction from rules versus principles. Thus, the latter does have this type of character what the first lacks: the possibility to put the weight. An example of this can be seen in Court: where the decision of the judge is an outcome of the weighting of principles. When rules conflict with each other, this is simply a leak in our legal system, as one of these rules has to be set apart. Principles put also relevance with the spirit of the law, as they are fundamental and reflect our society. The current tendency in our society on the practices of multinationals, who evade lots of taxes via aggressive tax planning, suggest the increased urgency to combat this. Principles cannot neglect this.\textsuperscript{574}

From an ethic view this results is in conflict with the fundamental idea of a society, where every citizen can rely on each other to contribute to the society.\textsuperscript{575}

Developments so far show that from the legislator point of view these measures are not sufficient. The legislator don’t see moral consider aggressive tax planning on the taxpayer and is not able to handle it via anti-abuse legislation, aggressive tax planning results in the ‘free riders’ of the world.\textsuperscript{576}

\textsuperscript{569} Happé, R.H., \textit{Multinationals, Enforcement Covenants and Fair Share}, Intertax, 35 (10), p.547.
\textsuperscript{570} See e.g., Avery Jones, J., \textit{Tax law: rules or principles}, British Tax Review 580, 1996.
\textsuperscript{573} Happé, R.H., \textit{Belastingrecht en de geest van de wet; een pleidooi voor een beginsel-benadering in de wetgeving}, Rede uitgesproken bij afscheid als hoogleraar aan Tilburg University, Tilburg, 2011, p.36.
\textsuperscript{574} As this is the open system of law: the interworking with the society. See Happé, R.H., \textit{Drie beginselen van fiscale rechtsbescherming}, Kluwer, Deventer, 1996, p.80 et seq.
\textsuperscript{575} Happé, R.H., \textit{Scribo ergo sum, over de strijd tussen de egel en de vos}, NJB 2010, p.856.
\textsuperscript{576} \textit{Ibid.}
Central to this idea is that the spirit of the law is lost. Therefore one should not apply tax planning constructions which are in conflict with this principle of the spirit of the law. This is the case when one knows that the legislator, if he had been aware of such construction, would have adapted the law. My plea is to take a different path in the anti-abuse ‘store’.

The ethical duty supports this path. The above mentioned compliance requirement should on a different way function and come into the legal domain. Therefore the tax legislator must opt for a principle based approach. Instead of specific rules should principles be recorded in the tax law, as the case is in the example from Happé of the Road Traffic Law.\(^{577}\) Hereby Art.5 of the Road Traffic Law is called ‘gevaarzetting’, a simple principle that covers the fact that during snowy conditions the maximum speed has to be enormously reduced, while this is not written down it is clear for everyone. In a clear context of imminent abuse of the law should be a specific anti-abuse principle the statutory norm. Core of the idea is of specific anti-abuse rules to be replaced by principles is that rules can be circumvented whereas principles simply cannot. Moreover, such legally established principles express the spirit of the law. Such an approach stresses not only the legal nature of tax law, but also the intrinsic link with social and ethical beliefs. The ethical notion connects the principle of the law. Especially in times of great economic and financial crisis the importance of ethics is crucial.

In this respect, also in taxation we must go back to the basics and be chary on the basic trust of our society via a measured approach. The spirit of the law is such measure. This provides guidance to the Aristotelian middle right to save.\(^\text{578}\)

To conclude: tax planning is big business, as so is aggressive tax planning. The latter pushes the borders of the law to gain as much tax advantage. Legislators react again and again with anti-abuse legislation. The face of the last decennia results in a vicious circle which seems to be open-ended without any hope on a solid solution to combat aggressive tax planning.\(^\text{579}\)

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578 Ibid., at 52.

The problems regarding the absence of ethics, moderate behaviour, compliance requirement and fair share duty are described. Combating these problems via the ethic point of view is not the aim of this research, but it’s good to first verify the ‘level playing field’ in order to move forward to a more practical approach. Therefore the problems of international tax arbitrage via tax planning will be seen from a principle point of view, in order to move forward to a more global tax system.

Recent development of the OECD, G20 and the EC, how good they are, tend to focus on exchange of information. Risk herein is that the real weaknesses on our current tax systems, which are exposed by the increasing global trade, are not solved. Of course, perfect or increased amount of exchange of information could reduce several problems regarding for example tax hases. However, as long as there is no global tax system or European tax system, tax competition will always exist and countries will still be played against each other.

This implies the need for revision of the allocation principles, at least on a national level. To conclude: to combat the current tension of aggressive tax planning with the spirit of the law, which seems impossible to intervene via rules, justifies a principle based approach.


7.3 Recommendations

Tax scholars and practitioners around the world have for centuries noted that the operation of national systems of taxation in the global context poses significant issues both for governments and for taxpayers operating across national borders. In general, taxpayers seek to avoid double taxation of their income (and otherwise minimize taxation of their income) by taxing authorities across borders. Nation-states, on the other hand, seek to preserve their taxing authority (and consequently impose taxes) as sovereign powers. The 1923 League of Nations Report on Double Taxation (the “League Report”) identified the principal issues in transnational taxation, at a time when national systems of taxation and global cooperation among these systems were far less robust than they are today.\textsuperscript{580} Coming back to the four economists, I don’t think that they won’t change their system and will still rely on the source rules. But what would they then do? Maybe they will adopt a origin based system? Or a destination based system? Maybe a totally new concept? Whatever they would do, this research has shown that some principles are less sensitive for aggressive tax planning.

During the writing of a draft-version of this research somewhere in May, there was a statement in the text which begun like this: ‘Last week the Dutch government became the 10\textsuperscript{th} to fall since the crisis began [... ] Nicolas Sarkozy may be its next victim’.\textsuperscript{581} Two months later the developments in the Euro-zone are continuing. In his Nobel Prize acceptance letter, Tom Sargent recently argued that Europe nowadays is where the USA was under the 1781 Articles of Confederation.\textsuperscript{582} This implies according to Sargent that the next step fiscal federalism, which means giving a federal Treasury some responsibility for the past borrowing of the member states, as happened with the adoption of the 1787 Constitution. The call for more coordination is also justified by the goal of Europe’s today monetary union: this was always meant to be a staging post on the road to a federal Europe. I have the feeling that the more we complain that we don’t want a fiscal union, the closer it is.

However aggressive tax planning is just a phenomenon aroused from the fact that the system is sick. Still in the current era it is determined to be legal. This could lead to the conclusion that rules are not suitable to combat this problem. Therefore a recommendation is that more relevance should be paid to the ethical point of view in this problem. Since this problem of international tax law is totally not solely a pure technical point of discussion, the entire world is involved in it.


\textsuperscript{581} According to e.g.: The Financial Times, Merkel can achieve fiscal union in Europe, 2 May 2 2012.

\textsuperscript{582} Sargent, T.J., United States then, Europe now, Nobel Prize Acceptance Letter, 1 February 2012. The letter is based on the Nobel Prize lecture held in Stockholm on December 8, 2011. Published by NY Law School.
A serious solution to the issue of double-non taxation (via aggressive tax planning) might result in an improving of the economic wealth of the more poor areas in the world. This shows the relevance of the ‘ethical approach’ in this respect. Therefore this approach should be taken more seriously and should play a bigger role in the discussions on solving the problem of aggressive tax planning.

Bart W.J. Konings
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