REGULATORY STRATEGIES TO CORPORATE GROUPS

Angeliki L. Vlachou

LLM (Catolica Global School of Law)

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Angeliki L. Vlachou

aggeliki.vlachou88@gmail.commailto:mjpschofield@gmail.com

Abstract

Executive Summary

The new economic reality poses an imperative need of abandoning the traditional approach of corporate law. Corporation law as the law of the individual entity does not offer the required flexibility for modern businesses to be competitive both on national and international level. Corporate group appears as the prevailing form of the modern business enterprise. Suffices it to say that the turnover of the eight largest multinational enterprises (Exxon-Mobil, BP, General Electric, Shell, State Grid) is higher that the global budget of six European member states, including Germany[1].

The present paper deals with the general theme of tax regulatory strategies to corporate groups by first analyzing the enterprise analysis doctrine as an innovative approach (Section I). Secondly, the currently prevailing provisions in the taxation of corporate groups in EU are going to be discussed (Section II)[2]. Section three (III) focuses in the future of group taxation in EU and especially on European Commission's efforts for creating a competitive European group tax regime by drawing up a Directive Proposal on a Common Consolidated Corporate Tax Base on March 16,2011.

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[1] Forbes Global Companies 2013, www.forbes.com (accessed January 10, 2015).

[2] This section is mainly based on information taken by Juhani Kesti, European Tax Handbook (IBFD, Amsterdam,2008) , Daniel Gutmann, Droit fiscal des affaires (Montchrestien, Lextenso editions, 2011), 194-196 and Daniel Gutmann, Lectures:Comparative Corporate Taxation (Université Paris 1 Panthéon-Sorbonne, Paris 2012).

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I. INTRODUCTION

Modern corporate law is greatly challenged with the economic reality of modern businesses. Increasing globalization asks for enterprises that can grow fast and function effectively in a national and international level. As Phillip Blumberg, one of the most prominent authors on corporate groups, has observed corporate groups of enormous size with complex multi-tiered corporate structures dominate the national and world economy[3]. The use of corporate groups to conduct a business creates great tensions with the traditional corporate law's notions of considering each company as a separate legal entity. However, being formed as single corporate entity with different divisions does not constitute an option for modern enterprises anymore. On the contrary, nowadays enterprises' strategy focuses on achieving market dominance through taking control of competitors[4]. To this objective, already since the end of 19th century, legally separate entities operate as a part of a larger economic enterprise under a unified management. The legal phenomenon of corporate groups has become a reality and the classical legal model of separate legal entities is in a serious crisis, giving its place in the new functional approach of "enterprise analysis".

Taking into account this new economic reality, enterprise analysis does not consider subsidiaries as separate legal entities, but as part of a larger economic enterprise guided by a parent company.For the enterprise analysis, the starting point is the actual business enterprise rather than the formal legal structures[5]. This means that we should consider a group of companies as a unit if there is a central controlling company and the component companies are economically integrated. Control and integration are the fundamental factors here.

The question is why do we need to determine the scope of enterprise applying a new doctrine and not the traditional entity law? The answer is simple. The traditional approach can be dysfunctional and sometimes can result in injustice and discriminations, since it neglects the reality of modern multinational enterprises[6].

Reflecting this doctrine, corporate groups' regulation tries to achieve its enterprise goals through a large number of complex provisions. Thus, corporate groups are specially

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[3] Phillip Blumberg, "Symposium: The Transformation of Modern Corporation Law: The law of corporate groups."Connecticut Law Review (2005): 605, 608.
[4] Alfred D. Chandler, Scale and Scope: The Dynamics of Industrial Capitalism (Cambridge, MA: Harvard University Press, 1990), 77.
[5] Kurt A. Strasser and Phillip I. Blumberg. "Legal Models and Business Realities of Enterprise Groups-Mismatch and Change." Law Research Paper Series Vol. 5 no 3 (2009):18/2009.
[6] Kurt A. Strasser and Phillip I. Blumberg, ibid.

regulated through exceptionally detailed rules in areas such as accounting, taxation, insolvency and antitrust law[7].

II. The different systems

Tax recognition of corporate group intends to allow the parent company to be the solely liable for corporation tax for all the component companies. This answers undeniably to the new group economic reality encouraging companies to develop their activities in a national and international level more effectively.

The problem posed by the anachronistic approach of considering each member of a group as a separate taxpayer can be illustrated by the following example. Let's assume that company A has realized under an exercise n, a net profit of 1000. This company A has a 100% subsidiary (company B), which has realized a deficit of 1000 under the same exercise n. If there is no tax provision for corporate groups, company A should pay its corporate tax (according to the rules of its state) and company B cannot do anything with its deficit, at least not immediately[8]. At the scale of the group A-B, considered it as a whole, exercise n results in the payment of a corporate tax (A pays its tax and B its tax), while the economic profit of the group A-B is zero.

Currently, many EU Member states have adopted a group taxation system. The fiscal consolidation system is a system known in most European countries, with the notable exception of Belgium, Greece and Hungary[9]. Initially this system has been introduced by Sweden in 1921 based exactly on the idea that the activity of a group should not be taxed differently than the same activity performed by a single entity. The real purpose of tax consolidation regime is to offset profits and losses among the group members. However, the procedures for this differ significantly from one Member State to another.

1. **Full consolidation (the Netherlands, Denmark, France).** The Netherlands approach is one of the most far-reaching, since it adopts effectively the enterprise analysis doctrine. The Article 15 of the 1969 Law on corporation tax allows a parent company and its subsidiaries to be taxed *"as if they were a single taxable*

[7] Andreas Cahn and David C. Donald, Comparative Company Law: Text and Cases on the Laws Governing Corporations in Germany, the UK and the USA (Cambridge University Press, September 2010), 677-689.
[8]It has the possibility to carry this deficit on the time by applying the rules of carry-back or carry forward, but this does not take into account the fact that this company functions within a wider union of companies.
[9] Until 2013 there was no special system for groups in number of recent Member States such as Bulgaria, Estonia, Tceque Republic, Romania, Slovakia and Slovenia.

person, with the activities and assets of the subsidiary forming part of the activities and assets of the parent company"[10]. In other words, everything is based on a fiction that the subsidiaries-members of the group have no legal personality. As a consequence, based on this fiction, everything is attributed to the parent company.Close to this approach is the Danish system. In Denmark all the results of the group-members are attributed initially to the parent company. In a second phase the global profit (or loss) is attributed proportionately to the profit-making (or loss-making) companies. Another example is the French system. France applies since the 1st of January 1988 a regime for corporate groups called "intégration fiscal". The article 223A of the French General Tax Code requires among other conditions the following: a) the parent company must be subject to corporate tax in France, b) the tax group can include only subsidiaries that are at least 95% owned (directly or indirectly) by the parent company[11].

2. **The German system/ Organschaft.** This model is based on the idea that the entities forming the group act on behalf of their parent company. The group members are being considered, for tax law purposes, as having no losses or profits. Consolidation is achievable by granting to the parent company the global result of the group, which is equal to the algebraic sum of the results of all group companies. The "organschaft" could be considered as being more flexible, especially comparing to the French system, since there is a requirement of 50% of ownership from the parent company. As a consequence, it focuses more on the flexibility needs of modern groups rather than on strict, ritualistic requirements.

3. **Group relief (UK, Cyprus, Ireland, Latvia, Malta, New Zeeland, Singapore).** This system allows the companies in a group to transfer contractually the losses among them. This system does not treat groups as a single entity for tax purposes. However, the fact that the transfer of losses is allowed makes the taxation of consolidated income effectively achievable.

4. **Group contribution or Scandinavian system (Sweden, Norway, Finland).** Contrariwise, the "group contribution" system allows profit transfers among the members of the group. Contractual agreements are the key for this system as well.

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[10] "Where a taxable person (the parent company) holds, legally and economically, at least 95% of the shares in the nominal paid-up capital of another taxable person (the subsidiary) and where both taxable persons so request, tax shall be levied on them as if they were a single taxable person, with the activities and assets of the subsidiary forming part of the activities and assets of the parent com pany. Tax shall be levied on the parent company. In that case, the taxable persons are together regarded as a tax entity. More than one subsidiary may form part of a tax entity."

[11] Daniel Gutmann, Droit fiscal des affaires (Montchrestien, Lextenso editions, 2011), 199-211.

There are specific provisions permitting legal agreements on transfer of profits between profit-making and loss-making group companies under the form of tax-deductible payments.

The basic concept underlying these provisions is that the group constitutes a unitary economic enterprise, despite the existence of distinct legal entities. However, this great diversity of corporate taxation contributes to an international tax competition, since some Member States focus on attractive investment conditions and others on securing their tax base. In addition to this, no Member State treats in the same way domestic and non-domestic corporate groups[12]. As a consequence, the single market advantages are significantly limited and fundamental freedoms issues have arisen.

Especially, intra-group loss offset has been at the ECJ's agent very frequently. In the cases of *Marks and Spenser*[13], *X Holding BV*[14], *Oy AA*[15], *Lidl Belgium*[16] and *Krankenheim Ruhesitz am Wansee-Senioremheimstaat*[17], the ECJ had to answered the crucial question whether the denial of loss offset, when a subsidiary is based on another Member State, is in line with the freedom of establishment principle. Among others the ECJ decided that excluding losses of a foreign permanent establishment from offset against profits of its domestic head office constitutes a restriction on the principle of freedom of establishment, but it can be justified. The ECJ ruled that the loss offset is compatible with the fundamental principles when it aims "*to create wholly artificial arrangements which do not reflect economic reality, with a view to escaping the tax normally due on the profits generated by activities carried out on national territory is such as to undermine the right of the Member States to exercise their tax jurisdiction in relation to those activities and jeopardize a balanced allocation between Member States of the power to impose taxes*[18]*".*

As it can be inferred, at the heart of the overall issue is the fact that there is no ECJ's ruling which forces the Member States to coordinate their fiscal regulations. In addition to this, in a European Level there is no common strategy, which establishes a

[12] Groups that are formed by subsidiaries based in different Member States than the one that the parent company is based.
[13] ECJ, *Marks & Spenser*, 13 December 2005 (C-446/03). Opinion of Advocate General Poiares Maduro delivered on 7 April 2005.
[14] ECJ, *X Holding BV*, 25 February 2010 (C-337-08).
[15] ECJ, *Oy AA*, 18 July 2007 (C-231/05).
[16] ECJ, *Lidl Belgium*, 15 May 2008 (C-414/06).
[17] ECJ, *Krankenheim Ruhesitz am Wansee-Senioremheimstaat,* 23 October 2008 (C□157/07).
[18] ECJ, *Oy AA*, 18 July 2007 (C-231/05), paragraph 62.

neutral tax regime[19] Consequently, this undoubtedly harms the internal market and postpones the goal of creating a European single market[20].

III. THE FUTURE OF GROUP TAXATION IN EU

The future of group taxation depends on the European legislator. The idea of coordination in groups' taxation came from a European Commission's study[21] on companies' taxation in the internal market. This study pointed out the various tax obstacles that block the achievement of an Internal Market. The ambition of the European Commission was to set up a real common consolidated corporation with uniform rules for all the corporate groups based in the EU. According to the Commission "the Common Consolidated Corporate Tax Base (CCCTB) for the EU-wide activities of companies is the only means by which companies in the Internal Market can overcome these difficulties in a systematic way and true Internal Market conditions can be established in the corporate tax field"[22].

To this objective the Commission has set up working groups composed of representatives of the business world, experts from Member States and the Commission's services. The task of these working groups was in fact to address all the technical issues in order to achieve the requested legal structure.

On 16 March 2011 Commission released a Directive Proposal on a Common Consolidated Corporate Tax Base[23]. The aim of this Directive is exactly to give effective solutions in international groups' taxation by establishing a body of homogeneous rules approved by all the Member States. This will promote the flexibility of European Corporate Groups, which will manage to adapt effectively to the new economic reality[24].

The CCCTB is a system of common rules for calculating the tax base of EU companies. These rules are applicably to companies, which are tax resident in the EU and

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[19] A neutral tax system is a system that influences business decisions as little as possible in order not to impact market development, which is apparently not the case in EU.

[20] Andreas Oestreicher, Christoph Spengel, Reinald Koch, "How to Reform Taxation of Corporate Groups in Europe", World Tax Journal (February 2011): 12,13.

[21] European Commission, Commission Staff Working Paper: Company taxation in the Internal Market (Brussels, Sec 2001, 1681, October 2001).

[22] Communication of the European Commission, An Internal Market without company tax obstacles achievements, ongoing initiatives and remaining challenges (Brussels, COM 2003 726 final, 24 November 2003).

[23] European Commission, Proposal for a Council Directive on a Common Consolidated Corporate Tax Base (CCCTB), (Brussels SEC 2011-315, SEC 2011-316, 16 March 2011).

[24] Christoph Spengel, Concept and Necessity of a Common Tax Base (Schön, Schreiber and Spengel, Common Consolidated Tax Base for Europe, Heidelberg, 2008), 26.

to EU-located branches of third-country companies. More specifically, the common fiscal framework provides for rules to calculate each company or branch's individual tax results. This consolidated base will be distributed proportionally to each eligible Member State. This distribution will be based on three factors under a mathematic formula: a) sales, b) labor and c) assets[25]. Within a single market where the economies of the Member States are tightly integrated, it becomes more and more difficult to determine the precise source of the taxable revenue. Therefore, this method aims to objectively identify and locate the main production factors for operating a fair distribution of the group's profits between the Member States that participate in its creation.

What we cannot overlook is the totally innovative character of this method. It is exactly based on the idea that the economic activity of a multinational company must be assessed in a unitary way, despite the fact that it is exercised through legally independent entities. It is literally a plunge towards the realization of a worldwide competitive European single market and a tremendous effort to adapt to the fast moving economic reality. The enterprise analysis doctrine tends to prevail the anachronistic approach and the group has started being considered as unique legal entity.

IV. <u>CONCLUSIONS</u>

The corporate groups taxation in Europe requires reform for several reasons. Firstly, in a corporate group, losses cannot be offset intra-group in all Member states, especially when it comes to cross-border situations. Furthermore, foreign subsidiaries are often subject to different tax treatment than their domestic counterparts, especially as far as loss offset is concerned. The absence of groups' regulation in many Member States and the existence of partial regimes (group relief and group contribution regime) constitute a serious drawback as far as the achievement of a real internal market is concerned.

European Commission and its innovative CCCTB proposal for group taxation in EU, try to deal with the elimination of shortcoming in traditional approaches of corporate tax law, which departs from the separate-entity theory. Eliminating shortcomings in prevailing corporate tax law cannot guarantee that all existing disadvantages are removed, but it is a promising move towards a modernization of the EU's corporate law.

[25] Article 86 of the CCCTB Proposal.

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