

# Taxation of Corporate Groups

Miguel Correia



*Published by:*

Kluwer Law International  
PO Box 316  
2400 AH Alphen aan den Rijn  
The Netherlands  
Website: [www.kluwerlaw.com](http://www.kluwerlaw.com)

*Sold and distributed in North, Central and South America by:*

Aspen Publishers, Inc.  
7201 McKinney Circle  
Frederick, MD 21704  
United States of America  
Email: [customer.service@aspublishers.com](mailto:customer.service@aspublishers.com)

*Sold and distributed in all other countries by:*

Turpin Distribution Services Ltd  
Stratton Business Park  
Pegasus Drive, Biggleswade  
Bedfordshire SG18 8TQ  
United Kingdom  
Email: [kluwerlaw@turpin-distribution.com](mailto:kluwerlaw@turpin-distribution.com)

*Printed on acid-free paper.*

ISBN 978-90-411-4841-4

© 2013 Kluwer Law International BV, The Netherlands

**DISCLAIMER:** The material in this publication is in the nature of general comment only. It is not offered as advice on any particular matter and should not be taken as such. The authors expressly disclaim all liability to any person with regard to anything done or omitted to be done, and with respect to the consequences of anything done or omitted to be done wholly or partly in reliance on the basis of any matter contained in this volume without first obtaining professional advice regarding the particular facts and circumstances at issue. Any and all opinions expressed herein are those of the particular author, they are not necessarily those of the publisher of this volume and they do not reflect the views of any institution or organization.

All rights reserved. No part of this publication may be reproduced, stored in a retrieval system, or transmitted in any form or by any means, electronic, mechanical, photocopying, recording, or otherwise, without written permission from the publisher.

Permission to use this content must be obtained from the copyright owner. Please apply to: Permissions Department, Wolters Kluwer Legal, 76 Ninth Avenue, 7th Floor, New York, NY 10011-5201, USA. Email: [permissions@kluwerlaw.com](mailto:permissions@kluwerlaw.com)

Printed and Bound by CPI Group (UK) Ltd, Croydon, CR0 4YY.

*To Maria João and little António Maria*



## About the Author

Miguel Correia is a lecturer in Comparative Corporate Taxation at the Católica Global School of Law and counselor for tax affairs at the Permanent Representation of Portugal to the European Union, in Brussels. He worked for several years as tax adviser for multinational corporate groups at the International Tax Group of PricewaterhouseCoopers LLP in New York and at the International Services Line of Deloitte in Lisbon. Miguel holds a PhD in Tax Law from the London School of Economics, an LLM from the Georgetown University Law Centre, and an LLM from the University of Essex. He completed his law degree at the Portuguese Catholic University.



# Table of Contents

About the Author	vii
Preface	xv
List of Abbreviations	xvii
List of Figures	xix
Introduction: Problem, Approach and Structure	1
I The Problem	1
II The Nature of CIT Law	2
III The Approach	5
IV The Structure of the Study	7
CHAPTER 1	
The Policy Approach	9
§1.01 The Core Structure of the CIT System	9
[A] The Concept of Realization	9
[1] The Advantages of Realization	10
[2] The Problems of Realization	13
[B] The Alternatives to a Realization-Based CIT System	15
[1] Accretion-Based Taxation	15
[2] Consumption-Based Taxation	18
[C] Taxing the Corporate Sector through a Corporate-Level Tax	23
[1] Corporate-Level Taxation and the Firm's Agency Problems	23
[a] The Reliability Effect	23
[b] The Deterrent Effect	24
[c] The Reversal of Clientele Effect	26
[d] The Control Effect	26
[2] Traditional Arguments for Defense of Corporate-Level Taxation	27
[D] Taxing the Corporate Sector in an Imperfect World	29
§1.02 The Corporation Income Tax and Corporate Behavioral Control	33

## Table of Contents

---

[A]	The Structural Distortions	33
[B]	The CIT and Corporate Behavioral Control	35
[C]	The Behavioral Control Instruments under a CIT System	36
[D]	The Types of Possible Behavioral Control	38
[E]	The Interaction Problems of CIT Behavioral Intervention	39
[F]	The Firm's Reaction to the Behavioral Control Instruments	41
	[1] The Current and Expected Future Tax Position of the Taxpayer	42
	[2] The Degree of Substitution to the Specific Tax Provision	42
	[3] The Stage of Development of the Firm	47
[G]	The Complexity of the CIT System When Used For Behavioral Control	49
[H]	Other Negative Consequences of Behavioral Control	51
[I]	CIT's Behavioral Control Instruments versus Direct Subsidies	52
[J]	CIT and Corporate Behavioral Control	54
§1.03	A New Policy Approach	58
	[A] A New Policy Approach to CIT	58
	[B] Issues Raised by the New Policy Approach	61
CHAPTER 2		
	The Taxation of Corporate Groups under the Standard CIT System	65
§2.01	The Nature of Corporate Groups	65
	[A] The Economic Nature of Corporate Groups	65
	[1] Beyond the Classic Distinction of Firm and Market	65
	[2] Unitary Economic Direction and Organized Internal Markets	68
	[3] The "Chameleon-like" Governance Structure	69
	[B] The Legal Nature of Corporate Groups	71
	[1] The Distortions to the Legal Structure of a Corporation Introduced by Intercorporate Control	71
	[2] The Corporate Group as a Legal Person	72
	[3] The Corporate Group as a Polycorporative Network	74
	[C] The Functional Nature of Corporate Groups	75
	[1] The Evolution of Functional Structures	75
	[a] From the Single-Unit and Single-Corporate Enterprise to the Multi-Unit and Polycorporate Enterprise	76
	[b] Centralized and Decentralized Governance Structures	77
	[2] The Functional Structures of Multinational Corporate Groups	78
	[a] The Modern Multinational Corporate Groups: Beyond the M-Form	78



Table of Contents

	[i]	Transnationality	79
	[ii]	Heterarchy	80
	[D]	Reconsidering the Nature of Corporate Groups	81
	[E]	Tax Policy and the Nature of Corporate Groups	82
§2.02		The Mechanics of the Standard CIT System	83
	[A]	The Basic Operational Structure of the Standard CIT System	83
	[1]	The Three Core Structural Pillars of the Standard CIT System	84
	[a]	Corporate-Level Tax	84
	[b]	Realization-Based Taxation	84
	[c]	Yearly Tax Assessment Rule	86
	[2]	The Secondary Structural Pillars	88
	[a]	Capital/Ordinary Income Divide	88
	[b]	Limitations on the Use of Losses	91
	[c]	Continuity of Interest Principle	92
	[d]	Dual Set of Tax Attributes	93
	[e]	Rules to Define and Treat Distributions	93
	[f]	Capitalization, Depreciation and Amortization Rules	94
	[B]	The Transactional Mechanics of the Standard CIT System	98
	[1]	Nature of Good Transferred	98
	[2]	Direction of Transactional Flow	102
	[3]	Ownership Thresholds	104
	[4]	Legal Instrument Adopted	106
	[C]	Structure, Form and Substance under the Standard CIT System	106
	[1]	The Basic CIT Principles and the Operational Structure of the CIT System	106
	[2]	The Significance of Form on Tax Treatment	108
	[3]	Economic Integration and Tax Treatment	111
	[a]	Economic Integration, Substitution and Discontinuity	111
	[b]	Economic Integration and Anti-abuse	113
§2.03		The Nature of Corporate Groups and the Standard CIT System	116
§2.04		The Dynamic Effects of Taxing Corporate Groups under the Standard CIT System	123
	[A]	The Manipulation of Legal Characterization	123
	[1]	Discontinuity, Substitution and Transaction Costs	123
	[2]	Perfect and Imperfect Substitution	124
	[B]	The Manipulation of Timing	126
	[C]	The Consequences of Manipulating the CIT System	126
	[1]	Complexity and Transaction Costs	126
	[2]	Reduction of Ability to Shift Capital to Its Most Efficient Use	127
	[3]	Agency Problems	127

## Table of Contents

---

	[4] Rigid and Potentially Sub-optimal Functional and Legal Structures	128
CHAPTER 3		
	The Tax Integration of Corporate Groups	131
§3.01	The Mechanics of Tax Integration	131
	[A] The Tax Integration Solutions	131
	[B] The Tax Integration of Corporate Groups through the Relaxation of the Standard CIT System's Anti-abuse Arsenal	132
	[C] The Interaction of Tax Integration Solutions with the Outside Environment	133
	[D] The Mechanic Structure of Tax Integration Solutions	136
§3.02	Closed Setting Framework: Common Issues	138
	[A] The Common Issues of Tax Integration Solutions	138
	[B] Eligible Entities	138
	[1] Residency	139
	[2] Control	139
	[a] The Definition of Corporate Group for General Regulatory Purposes	139
	[b] The Definition of Corporate Group for Tax Integration Purposes	141
	[i] The Criteria to Determine Control	141
	[ii] Power and Ownership	142
	[iii] Power and Economic Integration	147
	[iv] The Definition of the Boundaries of the Tax Group	149
	[3] Business Characteristics	149
	[C] Applicability Regime	152
	[1] Mandatory versus Elective Applicability	152
	[2] Procedural Aspects	155
	[D] Proportional versus Full Consolidation	158
§3.03	Closed Setting Framework: Mechanic Analysis	159
	[A] General Conceptual Framework	159
	[B] The Common Tax Base	167
	[1] Entry Issues	168
	[a] Entry Issues: Tax Losses	168
	[b] Entry Issues: Assets	174
	[2] Transfer of Tax Losses	176
	[a] The US Group Taxation Regime	178
	[i] The Floating Outside Basis	178
	[ii] The Determination of the Tax Liability of the Corporate Group	181

Table of Contents

		[iii] The Problem of Transfers of Tax Group Members' Stock	182
		[b] The Participation Exemption	185
		[c] Integration Approaches under a Common Tax Base with a Participation Exemption Regime	186
	[3]	Transfer of Assets	188
		[a] Option 1: Recognition Mechanics with Deferment of Tax Liability	190
		[b] Option 2: Disregard of Transaction	192
		[c] Option 3: Carryover Mechanics	193
		[d] Other Considerations	193
	[4]	Transfer of Income	194
	[5]	Exit Issues	197
	[C]	The Separate Tax Base	200
		[1] Entry Issues	202
		[2] Transfer of Tax Losses	204
		[3] Transfers of Assets and Income	208
		[4] Exit Issues	208
	[D]	The Single Tax Base	209
		[1] Entry Issues	210
		[2] Exit Issues	215
		[3] Other Considerations	217
	[E]	The Flow-Through Model with Multiple Owners	218
	[F]	Hybrid Models	222
		[1] The Molecular Model	222
		[2] Other Hybrid Models	225
§3.04		The Tax Rate	226
§3.05		The Tax Amount Payable	227
§3.06		Conclusion: The Mechanics of Tax Integration under a Closed Setting Framework	235
§3.07		The Dynamics of Tax Integration under a Closed Setting Framework	241
	[A]	Considerations on Efficiency	242
		[1] The Continuity of the Tax Rules in Intra-group Transactions	242
		[2] Optimization of Group Resources	243
		[3] Flexibility for Restructurings of Corporate Structures	244
		[4] Simplified Combination of Tax Attributes	244
	[B]	Analysis of Distortions and their Interactions	245
		[1] The Structural Distortions	245
		[a] The CIT System and Corporate Risk-Taking	245
		[b] No Relief for Losses	247
		[c] Relief with Full Refund	247
		[d] Relief without Refund but with Carryover Allowed	249

Table of Contents

---

	[i] Inter-Entity Loss Carryovers and Tax Integration	250
	[ii] Year Carryovers and Tax Integration	253
	[iii] Source Carryovers and Tax Integration	257
	[2] The Affirmative Use of Non-tax Law Frictions	257
	[3] The Nature of Corporate Groups	258
	[4] Tax and Regulation	258
§3.08	Conclusion: The Dynamics of Tax Integration under a Closed Setting Framework	260
§3.09	Taxing Corporate Groups under an Open Setting Framework	261
	[A] Efficiency under an Open Setting Framework	262
	[1] The Internal Efficiency of the MNG	262
	[2] Efficiency from the Perspective of the States	263
	[B] Fundamental International Tax Reform	265
	[C] Current Country Experience	268
	[1] Issue 1	268
	[2] Issue 2	270
	[3] Issue 3	271
	[4] Issue 4	271
	[a] Foreign Subsidiary	271
	[b] Foreign PE	274
	[c] Other Considerations	275
CHAPTER 4		
	Policy Guidelines	277
§4.01	General Guidelines	277
§4.02	Specific Guidelines on Tax Integration	282
	Appendix	289
	Glossary	305
	Bibliography	307
	Table of Statutes	325
	Index	331

## Preface

This book proposes an interdisciplinary and comparative approach to the taxation of corporate groups. It is fundamentally based on my PhD thesis, written and defended at the Law Department of the London School of Economics (LSE).

The book has four chapters. In the first, the study analyzes the core mechanical pillars of corporate income tax (CIT) systems and their impact on corporate behavior. The objective of this part of the study is to define a policy approach that may improve the traditionally cumbersome interaction between tax systems and corporate groups. In Chapter 2, following the policy principles developed in Chapter 1, the book starts by analyzing the economic, legal and functional nature of corporate groups. Then, it examines the fundamental mechanical operation of CIT systems assuming that no tax integration solution, such as group taxation or flow-through taxation, is applicable, and assesses the merits and shortfalls of taxing corporate groups in this manner. Conversely, in Chapter 3, the book analyzes how corporate groups may be taxed under tax integration solutions and investigates the consequences of adopting such a stance. The study concludes, in Chapter 4, by proposing a set of policy guidelines that should be considered when approaching the taxation of corporate groups.

The analysis undertaken results in the construction of a comprehensive conceptual framework, which I believe should greatly facilitate the work of those, from practitioners to researchers, wishing to understand more fully how corporate groups are taxed around the world.

This work was only possible due to the strong and consistent support of many individuals and institutions. I would like to briefly express my gratitude to them. First of all, I would like to thank Dr Ian Roxan, my doctoral supervisor at the LSE. It was a privilege to be able to profit from Dr Roxan's breath of perspective, continuous support and invaluable guidance throughout the several years of research this book required. I would also like to express my special gratitude to Dr Peter Harris, of the University of Cambridge, and to Professor John Avery Jones, of the LSE, for their detailed and critical reading of a prior version of this work and for their insightful comments and helpful recommendations. In addition, gratitude is owed to Dr António Frada de Sousa, Professor Miguel Poiares Maduro, Professor José Engrácia Antunes and Professor

## Preface

---

Leonard Terr for their key support during the early stages of the project; to Dr Ann Mumford, Professor Paul Davies and Professor Malcolm Gammie for their valuable inputs to the early materials that led to this study; and to Luís Barreto Xavier, dean of the Católica Global School of Law, and Professor Rui Duarte Morais, my post-doctoral supervisor, for their important support during the finalization stage. Other people who have contributed significantly to this work and whom I would like to thank include: Shari Beth Domow Bacsardi, for her incisive stylistic comments that greatly improved the text; and Lijntje Zandee, António Rocha Mendes and my colleagues at the Portuguese Catholic University, for their editorial commentary and insightful advice during the final stages of preparing this book. Lastly, but certainly not least, I would like to thank my family and my friends. Besides Porfirio, Teresa, Sofia, Ducha, Paulo and Joana, for whom all words would be too few, I would like to leave a special word of appreciation to my enthusiastic and inspiring creative consultants, Brito, João and Rui.

I would like also to express my gratitude to the sponsors who made this work possible. First, the Portuguese Government, which funded the bulk of the research through *Fundação para a Ciência e a Tecnologia*. Second, the UK Chartered Institute for Taxation and the Harbour Charitable Trust (Professor John Avery Jones Award), which funded the initial stages of the research.

I hope this book and the ideas here proposed may prove of value to the reader. Potential errors or inaccuracies are obviously of my sole responsibility.  
Brussels, December 2012.

## List of Abbreviations

ACA	Allocable Cost Amount (Australia)
ACE	Allowance for Corporate Equity
AF	Available Fraction (Australia)
ALI	American Law Institute
BNA	Bureau of National Affairs
CBIT	Comprehensive Business Income Tax
CFC	Controlled Foreign Corporation
CIT	Corporation Income Tax
CNOL	Consolidated Net Operating Loss (US)
CIRC	<i>Código do Imposto Sobre o Rendimento das Pessoas Colectivas</i> (Portuguese Corporate Tax Code)
CTA	Corporation Tax Act (UK)
ELA	Excess Loss Account (US)
ECJ	European Court of Justice
EU	European Union
EU CCCTB Directive	European Commission's Proposal for a Council Directive on a Common Consolidated Corporate Tax Base
E&P	Earnings and Profits (US)
FA	Finance Act (UK)
FMV	Fair Market Value
Ft.	Footnote
FTC	Foreign Tax Credit
GAAP	Generally Accepted Accounting Principles

## List of Abbreviations

---

HMRC	Her Majesty's Revenue and Customs (UK)
IAS	International Accounting Standards
IBFD	International Bureau of Fiscal Documentation
ICTA	Income and Corporation Taxes Act (UK)
IFA	International Fiscal Association
IFRS	International Financial Reporting Standards
IMF	International Monetary Fund
IRC	Internal Revenue Code (US)
IRS	Internal Revenue Service (US)
ITAA	Income Tax Assessment Act (Australia)
JCT	Joint Committee on Taxation (US)
LDR	Loss Disallowance Rule (US)
LLC	Limited Liability Company
MNG	Multinational Corporate Group
M&A	Mergers and Acquisitions
NBER	National Bureau of Economic Research
NCL	Net Capital Loss
NOL	Net Operating Loss
OECD	Organisation for Economic Co-operation and Development
OECD MC	Organisation for Economic Co-operation and Development's Model Tax Convention
PE	Permanent Establishment
Rev. Rul.	Treasury's Revenue Ruling (US)
Sch.	Schedule
SRLY	Separate Return Limitation Year (US)
SSRN	Social Science Research Network
TCGA	Taxation of Chargeable Gains Act (UK)
TCS	Tax Cost Setting (Australia)
TIOPA	Taxation (International and Other Provisions) Act (UK)
Treas. Reg.	Treasury Regulations (US)
VAT	Value-Added Tax



## List of Figures

Figure 2.1	The Standard CIT System's Fundamental Tax Equation	84
Figure 2.2	The Core Structural Pillars of the CIT System	88
Figure 2.3	The Mechanic Structure of the CIT System	96
Figure 2.4	The Standard CIT System's Tax Engine	97
Figure 2.5	The Tax Factors Associated with the Nature of the Good Transferred	98
Figure 2.6	The Nature of the Good Transferred: Transaction 1	99
Figure 2.7	Transaction 1: Tax Free	100
Figure 2.8	Transaction 1: Taxable	100
Figure 2.9	The Nature of the Good Transferred: Transaction 2	101
Figure 2.10	Transaction 2: Taxable	102
Figure 2.11	Direct Transactional Routes between Unrelated Corporations	103
Figure 2.12	Direct Transactional Routes between Related Corporations	103
Figure 2.13	Low Ownership Thresholds in Corporate Group Members	104
Figure 2.14	Medium Ownership Thresholds in Corporate Group Members	104
Figure 2.15	High Ownership Thresholds in Corporate Group Members	104
Figure 2.16	Transactional Flowchart	117

## List of Figures

---

Figure 2.17	Transactional Map for Intra-group Transfers of Built-in Gain Assets under the Standard CIT System	119
Figure 3.1	Interactions of the Tax Integration Solutions with the Outside Environment	135
Figure 3.2	The Core Blocks of the Tax Integration Solutions	137
Figure 3.3	Potential Eligibility Requirements to Access a Tax Group	152
Figure 3.4	Applicability Regime: Includable Members	153
Figure 3.5	Applicability Regime: Procedural Aspects	158
Figure 3.6	The Tax Integration Solutions: The Tax Bases	160
Figure 3.7	The Tax Integration Solutions: Intra-group Tax Loss Transfers	162
Figure 3.8	The Tax Integration Solutions: Spectrum of Transferable Tax Attributes	163
Figure 3.9	The Tax Integration Solutions: Pre-entry Tax Losses	163
Figure 3.10	The Tax Integration Solutions: Intra-group Asset Transfers	164
Figure 3.11	The Tax Integration Solutions: Pre-entry Issues for Assets	165
Figure 3.12	The Tax Integration Solutions: Intra-group Income Transfers	165
Figure 3.13	The Tax Integration Solutions: Dividends	166
Figure 3.14	The Tax Integration Solutions: Royalties, Interest, Rents, Service Fees	166
Figure 3.15	The Tax Integration Solutions: Exit Issues	167
Figure 3.16	The Common Tax Base: Pre-entry Tax Losses	173
Figure 3.17	The Common Tax Base: Pre-entry Issues for Assets	176
Figure 3.18	The Problem of Double Counting	177
Figure 3.19	The Floating Outside Basis of the US Group Taxation Regime	178
Figure 3.20	The Interactive Characteristics of Outside Basis under the US Group Taxation Regime	180
Figure 3.21	The Transfer of a Tax Group Members' Stock under the US Group Taxation Regime: Situation 1	182
Figure 3.22	The Transfer of a Tax Group Members' Stock under the US Group Taxation Regime: Situation 2	183

List of Figures

---

Figure 3.23	The Transfer of a Tax Group Members' Stock under the US Group Taxation Regime: Situation 3	183
Figure 3.24	The Problem of Intra-tax Group Asset Transfers	189
Figure 3.25	The Problem of Intra-tax Group Payments	196
Figure 3.26	The Common Tax Base: Exit Issues	200
Figure 3.27	The Separate Tax Base: Pre-entry Tax Losses	203
Figure 3.28	The Single Tax Base Model	209
Figure 3.29	Transactional Map for Intra-group Transfers of Assets under the Single Tax Base Model	210
Figure 3.30	The Flow-Through Model	219
Figure 3.31	The Tax Atom	222
Figure 3.32	The Tax Molecule	223
Figure 3.33	The Molecular Group Taxation System	224
Figure 3.34	Allocation of Consolidated Tax Liability: Model 1	232
Figure 3.35	Allocation of Consolidated Tax Liability: Model 2	233
Figure 3.36	The Spectrum of Loss Relief under a CIT System	246
Figure 3.37	Transactional Flowchart: Open Setting Framework	265
Figure 3.38	The Open Setting Framework: Issues	268
Figure 3.39	The Open Setting Framework: The Head of the Tax Group	269



# Introduction: Problem, Approach and Structure

---

## I THE PROBLEM

Corporate groups are notoriously difficult to tax. Due to their economic, legal and functional nature, they raise very complex issues when approached through the lens of contemporary CIT systems, which were largely devised based on the corporate law paradigm of the corporation as a self-sufficient and self-governing entity. Faced with the difficulty to deal with the dynamic nature of these entities, tax legislators oscillate between the attribution of a separate tax existence to corporate group members and the treatment of corporate groups as single taxable entities. This fuzzy approach to the taxation of corporate groups generates loopholes in the CIT systems and undermines their structural logic. The propensity for internal asymmetry and logical incoherence of CIT systems, a necessary outcome of their varied influences and structural constraints, makes the problem considerably worse.

In most OECD countries, as a reaction to the avoidance opportunities generated, a complex arsenal of anti-abuse rules has been developed and substantial developments in judicial anti-abuse doctrines took place. Corporate groups have reacted to these primarily piecemeal reforms by fostering organizational and transactional complexity in the exploration of innovative substitute transactions. This overall state of affairs currently results in a substantial deadweight loss for the entire economic system, creating problems for the government, the corporate groups and the society.

In light of the current state of affairs, the central question that this study proposes to answer is: *What is the best approach to tax corporate groups once both the perspectives of the government and the corporate groups are taken into consideration?* The answer to this core problem presupposes the answer to three different questions. First of all, how should research approach corporate taxation? Second, does it make sense to focus on potential improvements to the current CIT systems or, in light of other potentially available alternatives, should they simply be discarded as a viable option to tax the corporate sector? Third, and fundamentally, assuming there is merit to the

maintenance of a CIT system, how should we identify the reasons for a CIT system's difficulty to tax corporate groups and define a path for improvement of the status quo that may be beneficial both to the governments and the corporate groups?

The next section will try to provide an answer to the first question posed. This demands an understanding of the nature of the subject under study. Once this work defines its approach to corporate taxation, it will then present its proposed structure to address the remaining questions and tackle the core research problem.

## II THE NATURE OF CIT LAW

CIT law is molded by economic, political, social and ideological influences.<sup>1</sup> This permeability of CIT law to its historical and material context is a consequence of the important role it plays in the political and economic shaping of a society. To determine the proportion of revenues to be transferred from the private sector to the public sector to fund public goods (through a particular definition of the corporate tax base and the corporate tax rate), which economic activities to encourage or discourage (through the introduction of particular incentives and disincentives in the corporate tax laws), or when and how to stimulate overall economic activity (namely, through the reduction of the tax charge on the corporate sector and its transference to other sectors of society) is an endeavor that results in tension among several sectors of society.

In practice, different actors with distinct behavioral tendencies and aims become deeply involved in the tax legislative process. The legislator, the tax authorities, political parties, corporate lobbies and interest groups act in constant tension regarding the definition of CIT's objectives and particular legislative shape. Due to its important societal role, the CIT's legislative process is particularly competitive, with these different internal cultural forces trying constantly to shape it according to their particular interests.<sup>2</sup> The internal tension of these forces in the definition of the corporate tax laws is a central element in the definition of the corporate tax culture.<sup>3</sup>

1. See, e.g., AJAY MEHROTRA, *Mergers, Taxes, and Historical Materialism*, 83 *Indiana Law Journal* 881 (2008), at 955 ("[Tax] rules are a product not solely of economic ideas or legal logic, but also of changing social, political and economic conditions and interests – a product, that is, of historical sequence and material context."); AJAY MEHROTRA, et al., *The New Fiscal Sociology: Taxation in Comparative and Historical Perspective* (Cambridge University Press, 2009), at 1 ("In the modern world, taxation is the social contract.").
2. See ROBERT J. CLARK, *The Morphogenesis of Subchapter C: An Essay in Statutory Evolution and Reform*, 87 *Yale Law J.* 90 (1977), at 95.
3. See ROBERT CLARK, at 95 ("The principal internal forces that have shaped the corporate tax culture derive from the motivations and aspirations of its different groups of participants. *Each group – taxpayers, the Service, courts, and legislators – displays characteristic behavioral tendencies that are themselves cultural activities and part of the corporate tax culture as defined.*"). Emphasis added. See also AJAY MEHROTRA, et al., *The New Fiscal Sociology*, at 3-4 ("[T]axation establishes a dynamic relationship between the taxpayer and the state, in which there always exists a potential conflict of interest...*the form of tax obligations is constantly changing as different taxpayers and different rulers seek to renegotiate the relationship to their advantage...the possibility of tension will be continually reproduced rather than resolved.*"). Emphasis added; and ALLISON CHRISTIANS, *Historic, Comparative and Evolutionary Analysis of Tax Systems*, University of Wisconsin Law School – Legal Studies Research Paper Series, Working Paper No. 1131 (2010), at 289 ("[T]ax policy in most nations emerges through

Historically, it has significantly contributed to turning the process of CIT reform into a controversial and piecemeal endeavor that has often generated genetically asymmetric and logically incoherent tax rules and principles.<sup>4</sup>

The imperfections of the economic system and the behavioral nature of the corporate taxpayer bolster the propensity for the internal asymmetry and the logical incoherence of the CIT system. CIT rules are implemented in an imperfect economy, i.e., an economy with transaction costs and information asymmetries.<sup>5</sup> In this imperfect economy, valuation of assets, knowledge of the tax rules, compliance and administration have associated costs. These costs fundamentally determine the structure and operation of a CIT system. For instance, a theoretically sound tax solution may often be too unpractical to be implemented due to the transaction costs involved in the valuation of assets, the transaction and agency costs generated by too burdensome

---

repeated interactions between lawmakers, tax experts, and affected parties in the public and private sector. *These individuals are participants in the dynamic process of lawmaking and law enforcement that comprise the tax 'rule of law.' As such, they are also agents of change, as they continually respond to each other.*") Emphasis added.

4. See SIDNEY I. ROBERTS, et al., *A Report on Complexity and the Income Tax*, 27 Tax L. Rev. 325 (1972), at 339 ("[T]he tax law has not evolved gradually through the implementation of the lessons of history, but has evolved by a series of amendments superimposed upon each other, reflecting an immediate need for revenue, the popular demand for tax relief, the pressure of interested special groups or an effort to prevent some type of abuse."); MARTIN S. FELDSTEIN, *On the Theory of Tax Reform*, 6 J. Pub. Econ. 77 (1976), at 90-94 (author notes how changes in tax systems are often slow, piecemeal and subject to political compromises). See also DANIEL N. SHAVIRO, *An Efficiency Analysis of Realization and Recognition Rules Under the Federal Income Tax*, 48 Tax L. Rev. 1 (1992), at 11.
5. For purposes of this study, transaction costs are defined as "conditions impeding the carrying out of mutually beneficial exchanges...such [as]... information costs, costs of negotiating and contracting, and costs imposed by ... regulations." See ROBIN PAUL MALLOY, *Law and Economics: A Comparative Approach to Theory and Practice* (West Publishing Co. 1990), glossary at 163. See also RICHARD A. POSNER, *Economic Analysis of Law* (Aspen Publishers 5th ed. 1998), 3.1, at 39. Note that the definition of transaction costs in the literature is not consensual. The literature uses inconsistent and widely varying definitions of transaction costs. See, e.g., OLIVER E. WILLIAMSON, *Transaction Cost Economics: The Governance of Contractual Relations*, 22 J. L. & Econ. 233 (1979), at 233 (the concept of transaction costs "wants for definition"); GIDEON PARCHOMOVSKY & PETER SIEGELMAN, *Selling Mayberry: Communities and Individuals in Law and Economics*, 92 Cal. L. Rev. 75 (2004), at 94 (transaction costs are "notoriously difficult to define"); CAROL ROSE, *The Shadow of the Cathedral*, 106 Yale Law J. 2175 (1997), at 2184-2189 (distinguishing between Type I transaction costs that are incurred prior to bargaining and Type II transaction costs that arise after bargaining has begun); DOUGLAS W. ALLEN, *Transaction Costs*, in *The History and Methodology of Law and Economics*, Encyclopedia of Law and Economics Vol. 1 (Boudewijn Bouckaert & Gerrit De Geest eds., Edward Elgar Press. 2000), at 913 (stating that two definitions prevail in the literatures: one that defines transaction costs as only occurring when a market transaction takes place; the other defining transaction costs as occurring whenever any property right is established or requires protection); CENTO VELJANOVSKI, *Economic Principles of Law* (Cambridge University Press. 2007), at 48 (stating that there are two broad types of transaction costs – the physical costs of organizing trades and costs arising from strategic behavior). On the concept of information asymmetries see, e.g., CENTO VELJANOVSKI, *Economic Principles of Law* (Cambridge University Press. 2007), at 40; and ROBERT COOTER & THOMAS ULLEN, *Law and Economics* (Pearson 5<sup>th</sup> Ed. 2007), at 228. On the related concepts of Moral Hazard and Adverse Selection see, e.g., CENTO VELJANOVSKI, *Economic Principles of Law*, at 40 and 117; and ROBERT COOTER & THOMAS ULLEN, *Law and Economics*, at 53-54.

compliance requirements, or the degree of sophistication of the tax authorities.<sup>6</sup> Last, but certainly not least, the behavioral nature of the corporate taxpayer, which is in a constant struggle to maximize profits, and, thus, to reduce tax payments, introduces an additional external constraint to the design and the operation of the CIT system, since in their effort to reduce tax payments, corporations often distort the envisaged effect of the tax rules.<sup>7</sup>

On top of these external world constraints, the limitations imposed by other regulatory fields constrain the design and operation of CIT rules. CIT, both for practical and historical reasons, is built on certain concepts and theoretical blocks developed in other disciplines.<sup>8</sup> This places strict limits on CIT's development and internal logic, in that the clarification of certain core CIT concepts, such as the definition of income, the principle of realization or the definition of corporate control, may only be operated with reference to other disciplines, such as economics, accounting and corporate law.<sup>9</sup> In addition, on its daily application, CIT is in constant operational interaction with other regulatory fields.<sup>10</sup> This introduces a further limitation to CIT's design and operation, in that, at least from an optimal point of view, tax rules should interact properly with other relevant regulatory fields.<sup>11</sup>

Further, CIT law is conditioned by internal constraints. The logic of CIT's fundamental postulates, such as the separate tax personality of corporate entities and the realization principle, strongly determines the design and operation of the CIT system.<sup>12</sup> As will be further discussed, the development of CIT law tends to occur in a cumulative way, with new concepts building upon these fundamental postulates.<sup>13</sup> These postulates, which due to their intrinsic nature and to the particularities of the CIT's design process are genetically incoherent, contribute to the asymmetric development of the CIT law.<sup>14</sup> Lastly, certain core CIT policy principles pose a final layer of

- 
6. See, e.g., JOHN PREBBLE, *Why is Tax Law Incomprehensible?*, 4 *British Tax Review* 380 (1994), at 393 ("Tax law is founded not on principle, but on practicality."). See also *infra* Chapter 1 section §1.01 (discussing the impact of these external world constraints on the shaping of the current CIT system's structure).
  7. For a detailed discussion of this issue see *infra* Chapter 1 section §1.02[F].
  8. For instance, the realization concept derives in part from the accounting practice of when to include an increase in value on the balance sheet. By the same token, the Haig-Simons concept of income developed in economics and the definition of control for tax law purposes is based on corporate law concepts. See discussion *infra* at Chapter 2 section §2.02[C].
  9. As will be discussed, this organic connection to other regulatory fields contributes to the formation of tax laws of incongruent logical shapes and to the development of certain characteristics, such as rigidity, formalism and a frequent asymmetric treatment of materially identical situations, which introduce a high level of complexity to the tax laws. See discussion *infra* at Chapter 2 section §2.02[C].
  10. Namely, as will be discussed, corporate law and accounting. Depending on the CIT system, the interaction may be weaker or stronger. See discussion *infra* at Chapter 2 section §2.02.
  11. See DAVID M. SCHIZER, *Frictions as a Constraint on Tax Planning*, 101 *Columbia Law Review* 1312 (2001). See also discussion *infra* at Chapter 1 section §1.03 (arguing that the CIT system may be improved by optimizing the interaction between the tax system and other regulatory fields and discussing associated practical issues).
  12. See *infra* Chapter 2 section §2.02[A] (examining the impact of the principles of realization and corporate tax personality on a CIT system's structure).
  13. See *infra* Chapter 2 section §2.02[C].
  14. See *infra* Chapter 2 section §2.02[C].



constraint to the tax legislator, in that at the time of the reform, policy makers must consider the effect of proposed rules on core CIT principles such as efficiency, equity and the protection of existing property rights.<sup>15</sup>

In short, a wide range of elements influences and constrains the CIT law. These different influences and constraints, including the nature of the tax legislative process, the market imperfections, the behavioral nature of the corporate taxpayer, the relationship with other regulatory fields, the logic from CIT's basic postulates, and the need to comply with conventional tax policy principles, fundamentally determine the design and the operation of a CIT system. The CIT system's propensity for internal asymmetry and logical incoherence reflects these different influences and constraints.<sup>16</sup>

### III THE APPROACH

A wide range of elements influences and constrains the CIT law. Therefore, the proper apprehension of the problems under study demands that these different influences and constraints are factored into the analysis. This necessarily requires the adoption of an interdisciplinary approach to corporate tax policy whereby these elements are brought into the investigation. For this reason, this study adopts an interdisciplinary approach to corporate taxation, factoring into the analysis research from tax law, economics, corporate law, accounting, and business management literature.<sup>17</sup>

The internal asymmetry and logical incoherence of the CIT system, coupled with the different influences and constraints that must be brought into the analysis, require the engagement in complex balancing processes. In order to facilitate these processes, this study adopts an economic discourse. As will be demonstrated, the adoption of an economic discourse is an extremely valuable tool to allow for a clearer evaluation of the impact of the different elements involved in corporate tax policy analysis. Note that, although the study adopts an economic discourse, it will not engage in formal economic analysis. It will use, instead, a heuristic approach.

Further, in light of the nature of CIT law, this study believes that it may be more productive to adopt an analytical perspective that starts from the analysis of the

- 
15. See MARTIN FELDSTEIN, *On the Theory of Tax Reform*, at 90-94. See also *ibid.*, at 98 ("The inherent right to private property ... does not preclude established rules of taxation but does protect the individual from the arbitrary and unanticipated taking of property. To the extent that such protection of private property is considered part of our legal tradition, tax reforms that frustrate expectations and reduce wealth unexpectedly must be considered unjust.").
  16. These different influences and constraints also contribute to the current diversity of tax systems around the world. See, e.g., AJAY MEHROTRA, et al., *The New Fiscal Sociology*, at 14 ("[I]nstitutional contexts, political conflicts, and contingent events lead to a diversity of tax states in the modern world[.]").
  17. See, e.g., also recommending an interdisciplinary approach to tax research, MARGARET LAMB & ANDREW LYMER (eds), *Interdisciplinary Research in Taxation: Research Approaches and Bibliographic Survey* (The Institute of Chartered Accountants in England and Wales. 1999); SIMON JAMES, *Taxation Research as Economic Research*, University of Exeter, Working Paper No. 01/07 (2001); CHRISTOPHER NOBES & SIMON JAMES, *The Economics of Taxation* (Prentice Hall 7th ed. 2005).

existing CIT system and takes into consideration its different influences and constraints, than to assume a clean slate perspective.<sup>18</sup> For this reason, this study adopts a perspective of incremental change rather than a fundamental tax reform perspective.

The study generally adopts a closed economy perspective. This requisite approach allows for a more accurate application of the interdisciplinary data, especially from economics, and for a proper focus on the structural components of the problems which this study aims at.<sup>19</sup> Nonetheless, whenever relevant, open economy considerations will be brought into the analysis.

The analysis is based on the rules of the US Federal CIT system. This choice was taken due to the high level of development of American CIT law and doctrine. For most issues, a comparative analysis will follow.<sup>20</sup> The comparative approach will be used to allow for a better focus on the conceptual structure that underlies the problems to be tackled.<sup>21</sup>

- 
18. See MARTIN FELDSTEIN, *On the Theory of Tax Reform*, at 90-94 (author defends that policy makers do not start with a clean slate in designing tax systems and contends that the optimal tax reform of an existing situation likely differs from the optimal structure if one were able to design a tax structure de novo). As discussed, this is due to several elements, such as the need to coordinate a potential revamp of the existing CIT system with the remaining relevant regulatory fields or the difficulties associated with the political process of tax design and promulgation. See also *infra* Chapter 1 sections §1.01[D] and §1.03[A] (discussing this issue in more detail).
  19. Some of the economic research used in this study has assumed a closed economy setting.
  20. The study will refer to the tax laws of several countries other than the US. In the case of the United Kingdom, Portugal and Australia it will make specific reference to the relevant primary legislative sources. For the remaining jurisdictions (e.g., Austria, Canada, Denmark, Finland, France, Germany, Italy, Netherlands, New Zealand, Norway, Spain, Sweden, etc.), the analysis will be based on selected secondary sources. For these countries, although care has been taken to use the most up to date secondary sources available, it may not be excluded that legislative changes may have occurred in the meantime. Nonetheless, since the legislation of these countries is generally used to exemplify potential paths available for legislative action, the impact of such changes on the discussion undertaken may reasonably be expected to be marginal.
  21. See WILLIAM B. BARKER, *A Comparative Approach to Income Tax Law in the United Kingdom and the United States*, 46 *Catholic University Law Review* 7 (1996) (arguing that comparative analysis needs to confront the assumptions underlying tax law); VICTOR THURONYI, *What Can We Learn From Comparative Tax Law?*, 103 *Tax Notes* 459 (2004) (arguing that the purpose of comparative tax law is to focus on the elements that underlie legal thought, which are often inarticulated or taken for granted); and VICTOR THURONYI, *Comparative Tax Law* (Kluwer Law International, 2003). To better deal with the nature of the CIT laws, this study adopts an approach that mixes functional with economic elements. For a good general description of the different potentially available approaches to comparative tax law study (i.e., functional, cultural, critical and economic) see REUVEN S. AVI-YONAH, et al., *Global Perspectives on Income Taxation Law* (Oxford University Press, 2011), at 2-16. For the functionalist perspective see KONRAD ZWEIGERT & HEIN KOTZ, *Introduction to Comparative Law* (Oxford University Press 3rd ed. 1998). For criticisms to the functionalist perspective see PIERRE LEGRAND & RODERICK MUNDAY, *Comparative Legal Studies: Traditions and Transitions* (Cambridge University Press, 2003). Note that this study believes that the criticisms made to the functionalist perspective (such as the fact that it does not take into account cultural diversity) are not as relevant in corporate tax law due its predominantly technical nature (as opposed to, for instance, family law) and to the common identity of most of the problems to which it is generally applicable (i.e., corporate distributions, corporate restructurings, etc.). For the economic perspective see UGO MATTEI, *Comparative Law and Economics* (Michigan University Press, 1997); RAFFAELE CATERINA, *Comparative Law and Economics*, in *Elgar Encyclopedia of Comparative Law* (Jan M. Smiths ed., Edward Elgar, 2006). For the recent discussion on comparative tax law analysis see CARLO

For purposes of analysis, the CIT system will be segregated into two components. First, the *Standard CIT System*, which includes the rules for taxation of corporations per se,<sup>22</sup> with the exclusion of Tax Integration Solutions. Second, the *Tax Integration Solutions*, which include group taxation regimes and flow-through regimes. In turn, the analysis of each of these components of the CIT system is made in two distinct analytical stages, i.e., mechanic and dynamic analysis.

The purpose of the mechanic analysis is to study the technical structure of the CIT system. The analysis is made utilizing a transactional approach. Specifically, tax rules are analyzed in terms of end result achieved by a corporation for each transactional route used and form adopted to transact with other corporations. This approach allows for a different angle of analysis of the tax rules, i.e., it allows the analysis of the tax rules to be made from the perspective of their users. The dynamic analysis, in turn, aims at understanding the operation of the mechanical structure of the CIT system by studying its impact on taxpayer behavior.

The analysis is not concerned with transfer pricing, tax evasion and European Union (EU) law. Besides not being central to the purposes of this book, due to their breadth, each of these subjects would require its own separate treatment. Finally, the analysis deals solely with corporate income tax issues. It does not explore individual income taxes, indirect taxes or stamp and real estate taxes issues.

#### IV THE STRUCTURE OF THE STUDY

The study is divided into four chapters. In Chapter 1, it investigates how to approach the central research problem. First, it examines the core structure of the current CIT system and determines the advantages and drawbacks of taxing the corporate sector through a CIT system. The analysis assumes a world of costly contracting and political constraints. Based on the results from such analysis, the study determines whether it makes sense for research to focus on potential improvements to the current CIT system or whether, in light of other potentially available alternatives, the current system should simply be discarded in its entirety. Subsequently, the study examines the CIT system's impact on corporate behavior. Once the study determines whether it is valuable to pursue further work on the current CIT system, identifies its core strengths and problems, and understands the determinants associated with its impact on corporate behavior, it will then suggest how to approach the central research question.

---

GARBARINO, *Comparative Taxation and Legal Theory: The Tax Design Case of the Transplant of General Anti-Avoidance Rules*, 11 *Theoretical Inquiries in Law* 765 (2010); and OMRI Y. MARIAN, *The Discursive Failure in Comparative Tax Law* 58 *American Journal of Comparative Law* 415 (2010). See also, for some classical works, ALAN WATSON, *Legal Transplants: An Approach to Comparative Law* (University of Georgia Press 2nd ed. 1993); and ALAN WATSON, *Legal Transplants and European Private Law*, 4.4 *Electronic Journal of Comparative Law* (2000), available at <http://www.ejcl.org/44/art44-2.html> (author argues that comparisons may not be particularly worthwhile except when the legal systems are closely related); RODOLFO SACCO, *Legal Formants: A Dynamic Approach to Comparative Law*, 39 *The American Journal of Comparative Law* 1 (1991); and CEDRIC SANDFORD, *Why Tax Systems Differ: A Comparative Study of the Political Economy of Taxation* (Fiscal Publications. 2000).

22. This excludes trusts, corporations treated as disregarded entities, partnerships, etc.

In Chapter 2, following the policy guidelines developed in Chapter 1, the study will investigate how the Standard CIT System taxes corporate groups and the consequences of such taxation approach. In turn, in Chapter 3, the study will examine how Tax Integration Solutions tax corporate groups and will determine the consequences of adopting such a stance. After taking into consideration the perspectives of the government and the corporate groups, the study will conclude, in Chapter 4, by suggesting how best to approach the taxation of corporate groups.