

**SOCIO-POLITICAL CHALLENGES TO TAXING MULTINATIONALS:
DO CORPORATE TAX CUTS BENEFIT THE HOME JURISDICTION?**

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ABSTRACT

Governments and policymakers are increasingly faced with the trade-off of protecting their tax revenue bases (with, inter alia, cross-border anti-avoidance rules) and keeping up with increased international tax competition (exemplified by corporate tax cuts). Recently many jurisdictions have proposed further reductions to their corporate tax rates. This is exemplified by the US and UK, who have indicated the possibility of eventually reducing their headline corporate tax rates to 15%.

The pressure to reduce corporate tax rates is largely driven by the perceived effectiveness of attracting foreign investment through this measure. MNEs' apparent imperative to engage in tax-minimising behaviour is often justified by an 'efficiency' argument. This paper explores and expands on the literature by observing that it is arguably more efficient to implement economic rent taxation than simply reduce headline corporate income tax ('CIT') rates.

In doing so, this paper bridges the gap between economic theory, practical optimisation modelling and applied legal research. Specifically, this research consists of both a legal comparative analysis featuring case studies of the Belgian and Italian ACE-variants, with a focus on the political hurdles to implementing and sustaining these reforms. This is complemented by the simulation analysis of a tax-minimising multinational enterprise's (MNE's) behavioural responses to both existing and proposed tax regimes, and in particular to reductions in those regimes' CIT rates.

The results are particularly important considering the international 'race to the bottom' in tax rates coupled with the increasing budgetary pressures arising from ageing and growing populations' growing demand for publicly funded services. This paper aims to provide a useful reference point for policymakers' future considerations in relation to the implementation of corporate tax cuts and the taxation of MNEs.

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I BACKGROUND

The advent of the global digital economy has heightened opportunities for aggressive tax planning by multinational enterprises ('MNEs') and has spurred harmful tax competition between governments. Governments and policymakers are increasingly faced with the trade-off of increased international competitiveness to encourage investment from MNEs with the need to protect their tax revenue bases. This has resulted in the implementation of cross-border anti-avoidance rules such as thin capitalisation and transfer pricing rules to target tax base erosion from aggressive tax planning behaviour via cross-border intercompany activities. However, the literature often conflates these rules' ability to restrict tax deductibility with their ability to eliminate tax-induced distortions.

This has become a major concern in the academic and political debate on the future of international taxation, exemplified by the G20/OECD's base erosion and profit shifting ('BEPS') project, which aims to tax MNEs "*where economic activities take place and value is created*".¹ However, this raises politically charged issues associated with residence- and source-based taxation, recently culminating in the UK's implementation of a Diverted Profits Tax ('DPT'), which Picciotto observes is largely indicative of a source-jurisdiction earmarking its claim over US-based MNEs' earnings retained offshore.²

More recently, prominent members of the G20 have signalled their intention to eventually reduce their headline corporate tax rates; this is exemplified by the US and the UK, who are both now targeting reductions to their corporate income tax ('CIT') rates; to possibly as low as 15%.³ Given the tension commonly experienced by policymakers between lowering the headline rate of CIT as opposed to implementing economic rent taxes, this paper explores the extent to which tax policies to date may have influenced the implementation (or lack thereof) of ACE-variants.

¹ OECD, *Explanatory Statement: OECD/G20 Base Erosion and Profit Shifting Project* (2014); available at: <http://www.oecd.org/tax/beps-2014-deliverables-explanatory-statement.pdf>.

² "A strengthening of rules on controlled foreign corporations, which may result from another of the BEPS action plan points, would reinforce the tax claims of the MNC's home jurisdiction while also acting as a disincentive to shifting profits from source countries. The DPT seems to be an assertion of a tax claim from the source country side, pre-empting residence country claims that might result from such stronger CFC rules. The intention may be not only to influence the BEPS process but also to pressure the U.S. Congress to reform the U.S. CFC rules in subpart F": Picciotto S, 'The U.K.'s Diverted Profits Tax: An Admission of Defeat or a Pre-Emptive Strike?' [19 January 2015] *Tax Notes International* 239, 242.

³ See, for example, Lane M, 'Autumn Statement 2016: The impact on multinationals' (2016) 1333 *Tax Journal*.

II AGGRESSIVE TAX PLANNING AND ECONOMIC RENT TAXATION

Even though the cross-border issue cannot be isolated from the rest of the tax system,⁴ the focus of this paper is the cross-border dimension because distortions in tax laws are highly problematic in this context. A central thread in the literature concerning MNEs' aggressive tax planning behaviour is that the opportunities for these behaviours are created by the policymakers themselves, through the design of rules governing the taxation of MNEs' cross-border activities.⁵ For example, the phenomenon of thin capitalisation arises from the decisions of revenue authorities to create a tax-induced cross-border debt bias, which presents opportunities for tax base erosion.⁶

The tax-induced cross-border debt bias incentivises behavioural responses to take advantage of the international classification differences between debt and equity,⁷ and distorts MNEs' corporate financing decisions. MNEs are clearly at an advantage, with access to global debt and equity markets; various jurisdictions' tax rates; and, various tax systems in general. In the absence of international tax coordination, these opportunities are nearly impossible to eliminate. On the other hand, policymakers are increasingly faced with the competing objectives of remaining internationally competitive and encouraging foreign investment while also maintaining the integrity of their national tax bases.

An underlying assumption in this paper is that, provided MNEs can benefit from tax planning opportunities presented by existing rules including transfer pricing, arm's length, thin capitalisation and debt/equity rules, they will adjust their behaviour to maximise overall deductions in higher-tax jurisdictions to minimise the group-wide tax liability and, in turn, their overall net profit after tax.

Previous research by the author has examined the conceptual case for why it might be appropriate and feasible to restrict the tax deductibility of cross-border intercompany interest, dividends, royalties and lease payments given their mobility and fungibility.⁸ Specifically, whether it is preferable for MNEs to be subject to economic rent taxation, as is attained through reform proposals such as the allowance for corporate equity ('ACE'), in this context.

⁴ Grubert H and Altshuler R, 'Corporate Taxes in the World Economy: Reforming the Taxation of Cross-Border Income', in: Diamond J and Zodrow G (eds.) *Fundamental Tax Reform: Issues, Choices, and Implications* (Cambridge, MA: MIT Press, 2008), 319–321.

⁵ Genschel P and Schwarz P, 'Tax competition: A literature review' (2011) 9 *Socio-Economic Review* 339, 364.

⁶ Kayis-Kumar A, 'Thin capitalisation rules: A second-best solution to the cross-border debt bias?' (2015) 30(2) *Australian Tax Forum* (in publication); see also, Hanlon D, 'Thin Capitalisation Legislation and the Australia/United States Double Tax Convention: Can They Work Together?' (2000) 3(1) *Journal of Australian Taxation* 4.

⁷ Desai MA, Testimony before the *US Senate Committee on Finance and the US House Committee on Ways and Means* (13 July 2011); available at: <http://www.finance.senate.gov/imo/media/doc/DesaiTestimonyFinal.pdf>, 4.

⁸ Kayis-Kumar A, 'International Tax Planning by Multinationals: Simulating a Tax-Minimising Intercompany Response to the OECD's Recommendation on BEPS Action 4' (2016) 31(2) *Australian Tax Forum* 363; Kayis-Kumar A, 'Taxing Cross-Border Intercompany Transactions: Are Financing Activities Fungible?' (2015) 30(3) *Australian Tax Forum* 627.

A *Aggressive tax planning and tax competition*

Despite criticisms of aggressive tax planning behaviour by MNEs, the philosophical framework of free market capitalism appears to justify this behaviour.⁹ This is exemplified in the efficiency argument, which is oft-cited by MNEs as a justification for utilising tax havens on the basis that tax minimising behaviour can encourage greater investment by MNEs. While the economic literature espouses that the profit motive ensures that resources are being allocated efficiently, this reasoning hinges on the simplifying theoretical assumptions that firms operate in free and competitive markets. Yet, these underlying theoretical assumptions do not exist in the current global funding system. Only the largest MNEs are best positioned to exploit differences in jurisdictions' tax systems to minimise their tax liability. This process of tax arbitrage does not improve productivity nor does it constitute 'true' innovation.¹⁰ This is exemplified by the complexity and fungibility of cross-border intercompany transactions relating to passive or highly mobile income; specifically, interest, dividends, royalties and lease payments. Using these intercompany transactions, MNEs can shift intercompany expenses to, and intercompany income from, source countries to minimise tax payable with relative ease.¹¹

In the absence of a requirement to fully disclose these intercompany transactions in financial statements, cross-referencing the information reported to taxing authorities and reported in financial statements is a highly challenging task.¹² Further, if a subsidiary is a private company it does not even

⁹ The profit motive provides the justification for internalising benefits while externalising costs, which includes the minimisation of taxation.

¹⁰ Porter ME and Kramer MR, 'Creating shared value' *Harvard Business Review* (Boston), January-February 2011.

¹¹ "...the relative ease with which MNE groups can allocate capital to lowly taxed minimal functional entities (MFEs). This capital can then be invested in assets used within the MNE group, creating base eroding payments to these MFEs.": see further, OECD, *Public Discussion Draft, BEPS Action 8, 9 and 10: Discussion draft on revisions to Chapter I of the Transfer Pricing Guidelines (including risk, recharacterisation and special measures)*, 1 December 2014 – 6 February 2015, 38. For completeness, residence issues are beyond the scope of this thesis.

¹² Commentators such as De Simone and Stomberg observe that "Financial reporting for income taxes is so complex that even sophisticated financial statement users often ignore detailed tax disclosures" and "taxation is often viewed by the market as beyond meaningful analysis": De Simone L and Stomberg B, 'Do investors differentially value tax avoidance of income mobile firms?' (Working Paper, University of Texas at Austin, June 2012), 2. Consolidated accounts undergo intercompany eliminations so are not helpful in this regard. While some MNEs provide some detail regarding their intercompany transactions in their segment reports, this is not a requirement across the board. See further, "this large shift in pre-tax income without any corresponding change in revenues suggests the presence of significant intercompany payments – likely royalty payments attributable to the transfer of intellectual property into Ireland": Balakrishnan K, Blouin J and Guay W, 'Does Tax Aggressiveness Reduce Financial Reporting Transparency?' (Working Paper, Wharton School, University of Pennsylvania, 20 September 2011), 29.

need to disclose comprehensive financial statements in the source jurisdiction.¹³

Given the significance afforded to the design of rules countering aggressive tax planning behaviour by MNEs, it is necessary to consider the impacts of changing these rules, as detailed in the empirical literature. Keen has observed that, even though both multilateral cooperation and unilateral anti-avoidance rules may reduce MNEs' propensity to engage in profit shifting, this will likely also increase competitive pressure on FDIs. So, if MNEs in high-tax jurisdictions are rendered unable to engage in profit shifting there may be a greater incidence of relocating production to other jurisdictions.¹⁴ Further, in the absence of a requirement to fully disclose MNEs' intercompany transactions in financial statements, cross-referencing the information reported to taxing authorities and reported in financial statements is a highly challenging task.¹⁵ This is exacerbated by the requirements relating to accounting standards such that, if a subsidiary is a private company, it does not need to disclose comprehensive financial statements in the source jurisdiction.¹⁶ Accordingly, academics including Seto posit that "... *an unknown but presumably significant number of companies use aggressive intercompany pricing to reduce their overall tax liabilities and get away with doing so*".¹⁷

However, the principal *objective* of the tax system is to raise sufficient revenue. While the concept of sustainability encompasses environmental, institutional and fiscal sustainability, the focus of this paper is on fiscal sustainability because it is the most relevant factor given the scope of this paper.

¹³ Changes to disclosure obligations have enabled some private company subsidiaries to bypass the need to disclose comprehensive financial statements; see further: The Australian Government, Australian Accounting Standards Board (AASB) Standard, 'Application of Tiers of Australian Accounting Standards', AASB 1053, June 2010; available at: http://www.aasb.gov.au/admin/file/content105/c9/AASB1053_06-10.pdf.

¹⁴ Genschel and Schwarz, above n 5, 364.

¹⁵ Commentators such as De Simone and Stomberg observe that "*Financial reporting for income taxes is so complex that even sophisticated financial statement users often ignore detailed tax disclosures*" and "*taxation is often viewed by the market as beyond meaningful analysis*": De Simone L and Stomberg B, 'Do investors differentially value tax avoidance of income mobile firms?' (Working Paper, University of Texas at Austin, June 2012), 2. Consolidated accounts undergo intercompany eliminations so are not helpful in this regard. While some MNEs provide some detail regarding their intercompany transactions in their segment reports, this is not a requirement across the board. See further, "*this large shift in pre-tax income without any corresponding change in revenues suggests the presence of significant intercompany payments – likely royalty payments attributable to the transfer of intellectual property into Ireland*": Balakrishnan K, Blouin J and Guay W, 'Does Tax Aggressiveness Reduce Financial Reporting Transparency?' (Working Paper, Wharton School, University of Pennsylvania, 20 September 2011), 29.

¹⁶ For example, in the financial year ending 2014, Google Australia Pty Ltd's disclosure omitted itemising over \$35 million in expenses from its financial statement and the corresponding notes, not even categorising these expenses as 'COGS' and/or 'Other expenses'. Further, Google Australia Pty Ltd's intercompany financing activities were presumably classified as 'operating' activities, as the 'financing' section of the cash flow statement was entirely blank, with no details afforded in the notes.

¹⁷ Seto TP, 'Four Principles of Optimal Tax System Design' (Legal Studies Paper No 2008-36, Loyola Law School, March 2013), 5-6.

Although the term fiscal sustainability does not have an exact meaning,¹⁸ Pinto observes that “[f]iscal sustainability advocates relying on a stable revenue stream by decreasing reliance upon more volatile taxes”.¹⁹ This preference in favour of a more stable revenue stream is consistent with optimal tax theory.

B Current practice: A reactionary approach to aggressive tax planning

Governments and policymakers are increasingly faced with the trade-off of increased international competitiveness to encourage investment from MNEs with the need to protect their tax revenue bases. Tax competition is often considered a force that drives down corporate income taxes across countries in a ‘race to the bottom’.²⁰ This is a product of reactionary policies and the outcome of a reduced revenue take is reduced scope for fiscal stimulus due to tightened budget constraints.

The central argument of this paper is that tax-induced behavioural distortions (or inefficiencies) create profound problems for governments and policymakers²¹ and transcend normative perspectives.²² The OECD is currently considering best practice approaches to designing rules to prevent base erosion and profit shifting (‘BEPS’) by multinational enterprises (‘MNEs’). However, the OECD makes a distinction between combating BEPS and reducing distortions between the tax treatment of various methods of financing.²³ Yet, it is the decision of the revenue authorities to create distortions which actually results in said tax base erosion opportunities.²⁴ Rather than merely addressing the behavioural symptoms of these distortions, such as debt shifting via excessive interest deductions,²⁵ it is arguably more effective to instead align the tax treatment of cross-border intercompany transactions to eliminate the tax incentive for said tax planning behaviour.

¹⁸ Chalk NA and Hemming R, ‘Assessing Fiscal Sustainability in Theory and Practice’ (IMF Working Paper WP/00/81, April 2000), 3.

¹⁹ Wilson-Rogers N and Pinto D, ‘Tax Reform: A Matter of Principle? An Integrated Framework for the Review of Australian Taxes’ (2009) 7(1) *eJournal of Tax Research* 72, 80.

²⁰ Beroš MB and Beroš M, ‘Fairness through regulation? Reflections on a cosmopolitan approach to global finance’ (2013) 7(1) *The Journal of Philosophical Economics* 2; Genschel and Schwarz, above n 5.

²¹ Distortive effects are not merely inefficient; they also affect fairness and administrability: Seto, above n 17, 3.

²² Seto, above n 17, 6.

²³ It is clear that both the OECD’s BEPS project and the thin capitalisation rules’ *raison d’être* is primarily concerned with protecting national tax revenue bases, “*In discussing fixed ratio rules it is important to note that in some cases these tests were also introduced to play a wider tax policy role rather than with a focus on combating base erosion and profit shifting. For example, a number of countries introduced such rules specifically to reduce existing distortions between the tax treatment of debt and equity.*”: OECD, ‘*BEPS Action 4: Interest deductions and other financial payments*’ (Public Discussion Draft, 18 December 2014), 47.

²⁴ Hanlon, above n 5.

²⁵ Previous work by the author conceptualises the cross-border debt bias as the ‘disease’ and the behavioural response of MNEs of engaging in debt shifting or thin capitalisation as merely the ‘symptom’: Kayis-Kumar, above n 5.

Global tax systems have failed to adapt to the changes generated by globalisation, illustrating the consequences of ignoring principles of optimal tax system design. This paper posits simply that, *ceteris paribus*, economic distortions are likely to increase incentives for tax-induced behaviours; in particular, aggressive tax planning.²⁶

Aggressive tax planning is highly problematic because it erodes the tax revenue base. This is further exacerbated by the fact that it may sometimes be difficult to differentiate between tax planning and tax avoidance.²⁷ Even though aggressive tax planning is widely perceived as ‘unfair’, tax planning is actively encouraged by tax professionals²⁸ in part because it is statutorily, administratively and judicially condoned.²⁹

Accordingly, the behaviourally distortive effects of tax rules should be of primary concern – regardless of one’s normative perspective – and policymakers concerned about tax planning need to consider the efficiency of the lines they draw. As observed by the Australian Treasury over 4 decades ago:³⁰

“Departures from neutrality, whether in the form of concessions or lack of alignment between different taxes, are some of the principal building blocks which so-called ‘tax planners’ use to erect schemes of (legal) tax avoidance, often of a highly artificial kind ... The opportunities for practices of this kind are of concern not only because they do damage to the equity of the system, and the attitudes of other taxpayers to compliance with it, in that certain taxpayers (more predominantly the relatively well-to-do ones) reduce their tax relative to others”

The debt-equity distortion is a primary example of such a departure from neutrality. In the Australian context, the Henry Review observed that *“Tax-induced distortions to financing decisions should be reduced to avoid encouraging firms to rely excessively on debt finance and to avoid biasing other*

²⁶ Seto, above n 17, 5-6.

²⁷ See, for example, Freedman J, ‘Defining Taxpayer Responsibility: In Support of a General Anti-Avoidance Principle’ [2004] 4 *British Tax Review* 332.

²⁸ Seto, above n 17, 10-11.

²⁹ Authority for this proposition is *IRC v Duke of Westminster* [1936] AC 1 (House of Lords), in which Lord Tomlin stated: *“Every man is entitled if he can to arrange his affairs so that the tax attaching under the appropriate Acts is less than it otherwise would be. If he succeeds in ordering them so as to secure that result, then, however unappreciative the Commissioners of Inland Revenue or his fellow taxpayers may be of his ingenuity, he cannot be compelled to pay an increased tax”*; see also, in the US context: *Helvering v Gregory*, 69 F.2d 809, 810 (2d Cir. 1934), *aff’d*, 293 U.S. 465 (1935), where Justice Hand mirrored Lord Tomlin’s sentiment: *“Any one may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one’s taxes”*. These judicial statements reflect the appropriate role of judges in enforcing existing law, not on principles of sound tax design. See further, Seto, above n 17, 12.

³⁰ *Taxation Reforms: Problems and Aims*, Treasury Taxation Paper No 1, 1974; see further, Auerbach AJ and Hines JR, ‘Taxation and Economic Efficiency’ (NBER Working Paper No 8181, National Bureau of Economic Research, March 2001).

financial decisions, such as dividend payouts. However, it is difficult to reduce distortions to financing decisions without a business level expenditure tax such as an ACE”.³¹

Despite the well-established literature that a principled approach likely calls for the introduction of an ACE-inspired system, in the Business Tax Working Group (‘BTWG’) review conducted in 2012, there was a strong recommendation to lower the corporate income tax rate. The rationale for this recommendation was that it would encourage investment in Australia.³² Further, the BTWG suggested that “[a] reduction in the company tax rate would also reduce distortions in the tax system relating to financing decisions”.³³ While reducing the CIT rate may in turn reduce the magnitude of allowable debt deductions, eliminating the debt distortion arguably requires more than reductions to the headline corporate tax rate.

III CASE STUDIES OF ACE-VARIANTS: TO CUT CIT RATES OR INTRODUCE AN ACE-VARIANT?

As highlighted in the above section II, there is a marked tension commonly experienced by policymakers between lowering the CIT rate (coupled with base broadening measures) and implementing an economic rent tax such as the ACE (at the expense of tax revenue).³⁴ Further, leading commentators observe that, where a jurisdiction has repealed its ACE-variant, this was not brought upon by any fundamental problem with the theoretical ACE,³⁵ nor any technical flaw in the ACE system.³⁶ Rather, the abolition of these ACE-variants was simply in line with the dominant trend of reducing headline corporate income tax rates in the context of ‘tax-rate cut cum base broadening’.³⁷

There has generally been bipartisan support for a target of lowering CIT rates in the face of increasing

³¹ Henry K, Harmer J, Piggott J, Ridout H and Smith G, *Australia’s Future Tax System: Report to the Treasurer*, Commonwealth of Australia, December 2009, Part 2, Chapter B1–4, available at: http://taxreview.treasury.gov.au/content/FinalReport.aspx?doc=html/publications/Papers/Final_Report_Part_2/c_hapter_b1-4.htm.

³² The Australian Government, The Business Tax Working Group, *Final Report*, November 2012, available at: <http://www.treasury.gov.au/~media/Treasury/Publications%20and%20Media/Publications/2012/BTWG%20Final%20Report/Downloads/PDF/BTWG-Final-Report.ashx>.

³³ For completeness, the BTWG recommended that the ACE remain on the reform agenda, albeit as a longer term option: The Australian Government, The Business Tax Working Group, *Final Report*, November 2012, 6, available at: <http://www.treasury.gov.au/~media/Treasury/Publications%20and%20Media/Publications/2012/BTWG%20Final%20Report/Downloads/PDF/BTWG-Final-Report.ashx>.

³⁴ Shaviro D, *Should corporate tax reform efforts emphasize an “allowance for corporate equity” (ACE)?*, 3; available at: http://www.law.nyu.edu/sites/default/files/ECM_PRO_068214.pdf.

³⁵ Klemm AD, ‘Allowances for Corporate Equity in Practice’ (IMF Working Paper WP/06/259, November 2006).

³⁶ Keen M and King J, ‘The Croatian profit tax: an ACE in practice’ (2002) 23(3) *Institute for Fiscal Studies* 401, 417.

³⁷ Keen and King, above n 36.

international tax competition, largely prompted by the forces of globalisation as countries pursue highly mobile capital investments made by large MNEs.³⁸

However, the theory of capital income taxation in a small open economy, which concludes that the tax incidence for small open economies is shifted entirely to the domestic factors of production such as labour and land, assumes perfect capital mobility.³⁹

It remains unclear who ultimately bears the burden of corporate taxes, with Menezes observing that:⁴⁰

“The argument for a reduction in the corporate tax rate was predicated in part in the simple theory of tax incidence expounded above. There are, however, several reasons why labour might not bear most of the burden of corporate taxes. Indeed, the issue of who effectively bears the burden of corporate income tax is yet to be resolved.”

While this paper does not purport to enter this debate, given the global trend of lowering CIT rates it is instructive to briefly earmark the following six-fold reasons against said reform:⁴¹

First, the home bias persists, capital markets are not perfect⁴² and a CIT rate reduction in the host country only transfers tax revenues to countries that tax their MNEs on their worldwide income but allow foreign tax credits for the corporate taxes paid at source, thereby failing to change both the effective tax burden and the investment behaviour of MNEs;⁴³

Second, the empirical evidence on the actual corporate tax burden borne by wages remains unclear, with the literature strongly questioning the theoretical suggestion that the tax incidence for small open economies is shifted entirely to the domestic factors of production such as labour and land. Further, reducing the CIT rate does not result in immediate flow-on benefits to workers in the form of extra capital, higher productivity and wages;⁴⁴

Third, since the CIT is levied on both normal returns to capital and rents, a reduction in the headline

³⁸ Diamond J, Zodrow G and Carroll R, ‘Macroeconomic Effects of Lower Corporate Income Tax Rates Recently Enacted Abroad’ (Ernst & Young Report, Prepared for the Reforming America’s Taxes Equitably (RATE) Coalition, March 2013), 18.

³⁹ Theoretically, it is also inoptimal for a small open economy faced with perfect capital mobility to levy a source-based tax on the normal return to capital: Sørensen PB and Johnson SM, ‘Taxing Capital Income: Options for Reform in Australia’ (Australia’s Future Tax and Transfer Policy Conference, Melbourne Institute, Chapter 9) 179, 187.

⁴⁰ Menezes FM, ‘The Business Tax Reform Agenda’ (2012) 31(1) *Economic Papers* 3, 4.

⁴¹ Further, it is arguable that simply lowering the headline CIT rate does not constitute tax reform *per se*.

⁴² Chan et al. (2005); Menezes FM, ‘The Business Tax Reform Agenda’ (2012) 31(1) *Economic Papers* 3, 4.

⁴³ So, in order to protect the domestic corporate tax base, many countries implement thin capitalisation rules, transfer pricing rules, controlled foreign corporation (CFC) rules and additional anti-avoidance tax rules; OECD, ‘Tax Policy Reform and Economic Growth’ OECD Tax Policy Studies No 20, (Paris: OECD Publishing, 2010), 54.

⁴⁴ Auerbach (2006) and Gentry (2007); Felix and Hines (2009); Menezes FM, ‘The Business Tax Reform Agenda’ (2012) 31(1) *Economic Papers* 3, 4.

CIT rate will necessarily reduce the tax on economic rents; thereby reducing the tax on investment that would occur in any event.⁴⁵

Fourth, reducing the CIT rate will disproportionately benefit larger, more profitable firms, with no impact on already loss-making firms;

Fifth, the emerging literature focussing on the real economic effects of CIT rate changes shows that while CIT rate increases uniformly reduce employment and income, CIT rate reductions are ineffectual in boosting economic activity⁴⁶ except when implemented during recessions;⁴⁷

Sixth, further reductions to the CIT rate will widen the wedge between the highest personal income tax bracket and the CIT rate, implying that further reductions in the CIT rate should not be made in isolation from changes in personal income tax because this presents a further deviation from business structure neutrality.⁴⁸

These factors create considerable uncertainty regarding the benefits of CIT reductions.

Further, it is noteworthy that the CIT system has the highest efficiency costs among Australia's federal taxes, with the efficiency losses resulting from taxing normal returns likely to be above 40%.⁴⁹

On the other hand, taxing only economic rents results in no deadweight loss. However, as observed by Ganghof, "*The result was not only neoliberalism by surprise⁵⁰ but also neoliberalism by default ...interactions of economic, partisan and institutional factors may lock countries into rather inefficient tax structures, at least temporarily*".⁵¹ Accordingly, it is imperative to increase the efficiency of business taxation, where possible.

In this context, there are many reform proposals addressing the business taxation distortion, including the ACE, Cash flow tax, Comprehensive Business Income Tax ('CBIT'), DIT and Residence-based shareholder tax.⁵² Specifically, this paper's focus is the distortion between debt and equity financing.

⁴⁵ Menezes FM, 'The Business Tax Reform Agenda' (2012) 31(1) *Economic Papers* 3, 4.

⁴⁶ Mukherjee, Singh, and Zaldokas (2014) find that corporate tax cuts have no effect on innovation as measured by patent applications filed by stock market listed firms; Ljungqvist A and Smolyansky M, 'To Cut or Not to Cut? On the Impact of Corporate Taxes on Employment and Income' (NBER Working Paper No 20753, National Bureau of Economic Research, December 2014), 31-32.

⁴⁷ Ljungqvist A and Smolyansky M, 'To Cut or Not to Cut? On the Impact of Corporate Taxes on Employment and Income' (NBER Working Paper No 20753, National Bureau of Economic Research, December 2014), 8.

⁴⁸ Menezes FM, 'The Business Tax Reform Agenda' (2012) 31(1) *Economic Papers* 3, 5.

⁴⁹ Australian Government, Department of the Treasury, 'Australia's Future Tax System: Report to the Treasurer', December 2009 ('Henry Review'); Menezes FM, 'The Business Tax Reform Agenda' (2012) 31(1) *Economic Papers* 3, 5.

⁵⁰ Stokes SC, *Mandates and Democracy: Neoliberalism by Surprise in Latin America* (Cambridge: Cambridge University Press, 2001).

⁵¹ Ganghof S, 'The Politics of Tax Structure' (MPIfG Working Paper 06/1, Max Planck Institute for the Study of Societies, January 2006), 26-27.

⁵² See Sørensen PB, 'Can Capital Income Taxes Survive? And Should They?' (2007) 53(2) *CESifo Economic Studies* 172, Table 4, 218.

A comparison of various fundamental reforms' impact on the debt bias is extracted in the below Table 1. Of these reforms only the ACE has been experimented with in practice.

Table 1 – Comparison of fundamental reforms' impact on the debt bias

Corporate tax-induced distortions/neutral corporate tax treatment												
Debt >> equity					New equity >> retained earnings					Depreciation		
	Corporate level:		Corporate tax + personal level taxes (domestic)		Corporate level: domestic	Corporate level:		Corporate tax + personal level taxes (domestic)			Tax >< economic depreciation	Impact of inflation on depreciation
	domestic	international ¹	Capital gains taxed upon accrual	Capital gains taxed upon realisation or at a lower rate		international ¹	Capital gains taxed upon accrual	Capital gains taxed upon realisation or at a lower rate				
							Normal return	Economic rents				
CIT in most countries	D	D	D	D	N	N	N	D	D	P	P	
Full imputation	D	N/D	N	D	N	N	N	D	D	P	P	
ACE/ACC	N	N	N	D	N	N	N	D	D	N	N	
ACC + PCIT	N	N	N	N	N	N	N	N	N	N	N	
ASE	D	D	N	N	N	N	N	N	D	P	P	
Shareholder ACE	D	N/D	N	N	N	N	N	N	D	N	N	
CBIT	N	N	N	N	N	N	N	N	N	P	P	
Corporate cash-flow	N	N	N	D	N	N	N	D	D	N	N	

D = distorted, N = neutrality, P = possibly neutral, PCIT = presumptive capital income tax.

1. Only the host country's corporate tax rate is considered.

Source: OECD (2007)

The focus of this paper is the ACE reform proposal. The ACE maintains the current deductibility of actual interest payments and adds a notional return on equity to be deductible against corporate profits; at the risk-free nominal⁵³ interest rate.⁵⁴

The ACE has garnered substantial support from leading academics since its theoretical inception and is experiencing increased interest from policymakers internationally.⁵⁵ In terms of its historical development, the ACE originated in the 1970's with the basic economic idea contained in the report

⁵³ "calculated by reference to a normal commercial rate of interest, fixed by the government"; see further, Gammie M, 'Corporate tax harmonization: an "ACE" proposal: harmonizing European corporate taxation through an allowance for corporate equity' (1991) 31(8) *European Taxation Journal* 238–242.

⁵⁴ De Mooij RA and Devereux MP, 'An applied analysis of ACE and CBIT reforms in the EU' (2011) 18(1) *International Tax and Public Finance* 93, 96.

⁵⁵ Keuschnigg C, 'The Design of Capital Income Taxation: Reflections on the Mirrlees Review' (2011) 32(3) *Fiscal Studies, Institute for Fiscal Studies* 437–452; Gammie M, 'Corporate tax harmonization: an "ACE" proposal: harmonizing European corporate taxation through an allowance for corporate equity' (1991) 31(8) *European Taxation Journal* 238–242; Devereux MP and Sørensen PB, 'The corporate income tax: international trends and options for fundamental reform' (2006) *European Economy*, Economic Paper 264.

of the Meade Committee,⁵⁶ which proposed alternatives to the UK tax system. This was followed by research published by leading commentators Boadway and Bruce,⁵⁷ and was further elaborated in detail by the IFS Capital Taxes Group,⁵⁸ and Devereux and Freeman.⁵⁹

The literature has predominantly focused on economic concepts, despite recognising the relevance and importance of law, accountancy and politics.⁶⁰ Further, the ACE literature currently has a corporate tax neutrality focus grounded in the economics paradigm. Importantly, ACE-based reforms have great potential from an anti-avoidance law perspective, which is especially pertinent for international company tax purposes.⁶¹ Further, simulations by de Mooij and Devereux show that even with the inclusion of tax havens, which halve the positive welfare effect of implementing a revenue-neutral ACE in high-tax countries, a European ACE still raises welfare. De Mooij and Devereux observe that the benefits of a more efficient tax system in terms of both investment and financial structure significantly outweighs the negative spill overs *vis a vis* profit shifting.⁶²

The original objectives and perceived benefits of ACE include encouraging domestic investment and employment, and achieving tax neutrality by granting tax relief for equity financing. In principle, many leading commentators, policy makers and corporations support ACE. However, implementing and sustaining fundamental reform of the corporate income tax system is difficult. Accordingly, it is necessary to consider how ACE eventuates in practice.

A *Applied literature analysing ACE-variants*

The majority of the English-language ACE literature provides a distinct focus on economic modelling rather than engaging in any legal analysis.⁶³ One of the exceptions is an OECD report providing a

⁵⁶ Institute for Fiscal Studies, *The Structure and Reform of Direct Taxation* (George Allen & Unwin: 1978); available at: <http://www.ifs.org.uk/docs/meade.pdf>.

⁵⁷ Boadway RW and Bruce NDB, 'A general proposition on the design of a neutral business tax' (1984) 24(2) *Journal of Public Economics* 231.

⁵⁸ Institute for Fiscal Studies, *Equity for Companies: A Corporation Tax for the 1990s*, Fourth report of the IFS Capital Taxes Group, Commentary No 26 (Chameleon Press: 1991), available at: <http://www.ifs.org.uk/comms/comm26.pdf>.

⁵⁹ Devereux M and Freeman H, 'A general neutral profits tax' (1991) 12(3) *Fiscal Studies* 1.

⁶⁰ Auerbach AJ, Devereux MP, Simpson HD, 'Taxing Corporate Income', Chapter 9 in J. Mirrlees et al (eds) *Dimensions of Tax Design: The Mirrlees Review* (2010) Oxford University Press; see also, Keuschnigg C, 'The Design of Capital Income Taxation: Reflections on the Mirrlees Review' 2011 *Fiscal Studies*, *Institute for Fiscal Studies* 32(3) 437–452; see further, Cooper GS, 'Implementing an allowance for corporate equity' (2012) 27 *Australian Tax Forum* 241–271.

⁶¹ Bond S, 'Company Tax Issues' (Presentation delivered to The Institute for Fiscal Studies, 2006).

⁶² De Mooij and Devereux, above n 54, 115.

⁶³ Staderini A, Tax reforms to influence corporate financial policy: The case of the Italian business tax reform of 1997-98, Banca D'Italia Working Paper No 423, November 2001; Giannini S, 'Le riforme italiane nella tassazione di impresa negli anni '90 in una prospettiva europea', (Paper presented at Seminario di Economia Pubblica Istituto di Economia e Finanza: Università Cattolica del Sacro Cuore, 22 February 2001); Oropallo F

descriptive exposition with detailed reference to particular amendments and developments, yet there remains a gap in relation to a critical analysis geared at suggesting design improvements for similar reforms in the future.⁶⁴

A recent contribution in this area has been the comparative analysis of the Belgian and Italian ACE-variants by Zangari,⁶⁵ who presents the case for why the design of the Italian ACE-variant allows for a more robust reform than the Belgian NID; namely, due to its anti-avoidance framework. However, Zangari refers to the Belgian and Italian ACE-variants as “*opposite reference points*”,⁶⁶ which is contrary to the description provided by De Mooij and Devereux; specifically, that these two ACE-variants are the closest to the theoretical ACE.⁶⁷ Further, despite providing a comparison between the technical aspects of these ACE-variants in practice, Zangari does not provide an in-depth legal analysis.

Accordingly, there remains scope in the literature to provide a more thorough comparative analysis, with an emphasis on legislative drafting and the underlying policy intentions for amendments over time. Accordingly, the following sections analyse the Belgian and Italian ACE-variant experiences, with a focus on the political hurdles to implementing and sustaining these reforms.

Another aspect of the ACE that has received little attention in the literature to date is that ACE-based reforms have potential to be applied as part of a broader anti-avoidance framework. It is plausible that this would be particularly useful when dealing with cross-border issues.⁶⁸ Accordingly, ongoing research by the author explores the relationship between the ACE and cross-border anti-avoidance rules in practice from a legal perspective, which is a current gap in the literature.

B *Belgium’s ACE-variant*

The Belgian corporate tax system is considered a classical double taxation system, modified by an exemption for dividends from qualifying participations held by corporate shareholders and a reduced

and Parisi V, ‘Will Italy’s Tax Reform Reduce The Corporate Tax Burden? A Microsimulation Analysis’ (2005) SIEP Working Paper No 403, Pavia; Federici D and Parisi V ‘Corporate taxation and exports’ (MPRA Paper No 41012, Munich Personal RePEc Archive, 3 September 2012).

⁶⁴ OECD, *Action Plan on Base Erosion and Profit Shifting* (Paris: OECD Publishing, 2013).

⁶⁵ Zangari E, ‘Addressing the Debt Bias: A Comparison between the Belgian and the Italian ACE Systems’ (European Commission Taxation Papers, Working Paper No 44, July 2014), 49.

⁶⁶ Zangari, above n 65, 6.

⁶⁷ De Mooij R and Devereux MP, ‘Alternative Systems of Business Tax in Europe: An applied analysis of ACE and CBIT reforms’ (European Union Taxation Papers, Working Paper No 17, 2009).

⁶⁸ Bond, above n 61.

rate for dividends from participations held by individual shareholders.⁶⁹ Tax practitioners have long considered Belgium an interesting jurisdiction for various tax-planning and structuring purposes.⁷⁰

Even prior to the introduction of the Notional Interest Deduction ('NID'),⁷¹ dividends could be received nearly tax-free, interest paid on loans taken out to acquire shares was tax-deductible and capital gains on shares were generally tax-exempt.⁷² The NID (otherwise known as the "*Intérêts notionnels et déduction fiscales pour capital à risque*", "*Notionele Interestaftrek*" or "*Capital Risk Deduction*") was introduced in 2005 to encourage equity financing following two key pressures; first, pressure from the European Commission to abandon the Belgian coordination center regime.⁷³ Second, following the expansion of the EU to countries with lower corporate tax rates, such as Cyprus, Latvia, Lithuania, and Hungary, which emphasized the need for Belgium to strengthen its position on the international tax map.

1 *Belgian NID: Political hurdles to implementation*

When initially introduced in Belgium, leading commentators observed that Belgium's NID reform was very close to the pure version of the ACE,⁷⁴ with the Parliamentary focus appearing to be the tax neutrality property of the NID to overcome the debt-equity distortion.⁷⁵ The originating explanatory notes⁷⁶ detail the political, philosophical, economic and tax policy rationales for implementing the Belgium ACE-variant, and the anticipated impact of this reform.

However, it is also important to recognise that Belgium did not have wide political support for the

⁶⁹ Široký J, 'There are several factors, which influence the actual range of the corporate tax: the relation between the personal income tax and the corporate income tax', 2006, available at: http://kvf.vse.cz/storage/1168944278_sb_siroky.pdf, 5.

⁷⁰ Liebman H, 'International Tax Planning: Belgium Is Taking Steps to Enhance Its Attractiveness', 2005, available at: <http://www.jonesday.com/international-tax-planning-belgium-is-taking-steps-to-enhance-its-attractiveness-07-26-2005/>.

⁷¹ *Loi du 22 juin 2005 instaurant une déduction fiscale pour capital à risque – Wet tot invoering van een belastingaftrek voor risicokapitaal van 22 juni 2005* [Law introducing an allowance for corporate equity of 22 June 2005], published in [Belgian Official Gazette of June 30, 2005](#), page 30077 (*Notionele Interestaftrek, Belgisch Staatsblad / Loi instaurant une déduction fiscal pour capital à risqué, Moniteur Belge*).

⁷² Liebman H, 'International Tax Planning: Belgium Is Taking Steps to Enhance Its Attractiveness', 2005, available at: <http://www.jonesday.com/international-tax-planning-belgium-is-taking-steps-to-enhance-its-attractiveness-07-26-2005/>.

⁷³ Quaghebeur M, 'Belgium Targets Risk Capital Deduction Abuses' (2007) *Tax Notes International* 12 November, 627; available at: <http://taxbites.be.apache05.hostbasket.com/pdf/t086.pdf>.

⁷⁴ Gerard M, 'Belgium Moves to Dual Allowance for Corporate Equity' (2006) 4 *European Taxation Journal* 156–162; De Callatay E and Thys-Clément F (Eds.), *The Return of the Deficit: Public Finance in Belgium over 2000–2010* (Belgium: Leuven University Press, 2013), 111–112.

⁷⁵ De Callatay and Thys-Clément, above n 74, 112.

⁷⁶ *Loi du 22 juin 2005 instaurant une déduction fiscale pour capital à risque – Wet tot invoering van een belastingaftrek voor risicokapitaal van 22 juni 2005* (Belgium) [Law introducing an allowance for corporate equity of 22 June 2005], 30 June 2005, 30077.

NID reform; indeed, the green and socialist parties opposed the NID, which was criticised as being used as “*a weapon in the election campaign of 2004*”.⁷⁷ Further, the rationale of highlighting the urgency of the NID in light of the dramatic decline in investment in Belgium was criticised in the parliamentary debates as a rushed and underhanded political strategy.⁷⁸ Despite ongoing political debate for over one year, which resulted in limitations to the NID, there were only 2 parliamentary sittings, which was criticised as resulting in insufficient debate on the broader reform of corporate income tax.⁷⁹ This was considered especially problematic by opposition parties, who made comparisons to the reform processes in neighbouring countries such as The Netherlands.⁸⁰

Nonetheless, the parliamentary debates indicate that a large majority of the committee subscribed to the philosophy underpinning the reform, with the proposal receiving generally positive feedback and unconditional approval by the VLD (the Flemish liberal party).⁸¹ However, the design parameters had mixed reviews; some parliamentarians believing the design was too generous and others considering it inadequate. The Finance Minister Didier Reynders interpreted this as indicating that the Bill was balanced,⁸² and earmarked an evaluation period to identify areas for improvement.⁸³ At its inception, this Bill was touted as a pioneer in tackling tax discrimination between debt and equity finance.⁸⁴

However, there has been much scepticism about the real motivation for implementing this reform, as observed by the National Bank of Belgium:

*“The memorandum put to the Parliament stresses the neutrality property of the reform because it enables corporate income tax to overcome the well-known debt equity bias. It ends by indicating that the reform also provides an alternative for financial companies using the coordination centre regime. Most would argue – rightly – that of the two motivations the second was the more important and the neutrality properties are more a consequence of the reform than its main policy motivation”.*⁸⁵

When it was introduced, Finance Minister Didier Reynders and Prime Minister Guy Verhofstadt organized roadshows in Asia, the United States, and India to promote the NID and explain that the

⁷⁷ *Chambre des Représentants en Belgique, Compte Rendu Intégral avec Compte Rendu Analytique Traduit des Interventions – Belgische Kamer van Volksvertegenwoordigers, Integraal Verslag met Vertaald Beknopt Verslag van de Toespraken* (Belgium) [House of Representatives, Full Report with a Summary Record of Translated Interventions], 22 June 2005, Paragraph 15.02, 59.

⁷⁸ *Chambre des Représentants en Belgique*, above n 77, Paragraph 15.12, 59.

⁷⁹ *Chambre des Représentants en Belgique*, above n 77, Paragraph 15.12, 59–60.

⁸⁰ *Chambre des Représentants en Belgique*, above n 77, Paragraph 15.20, 61.

⁸¹ *Chambre des Représentants en Belgique*, above n 77, Paragraph 15.01, 53.

⁸² *Chambre des Représentants en Belgique*, above n 77, Paragraph 15.01, 53–54.

⁸³ *Chambre des Représentants en Belgique*, above n 77, Paragraph 15.01, 58.

⁸⁴ *Chambre des Représentants en Belgique*, above n 77, Paragraph 15.01, 58–59.

⁸⁵ De Callatay E and Thys-Clément F (Eds.), *The Return of the Deficit: Public Finance in Belgium over 2000–2010* (Belgium: Leuven University Press, 2013), 112.

deduction reduced the corporate income tax rate from 33.99% to about 26%.⁸⁶ They were accompanied by representatives of some banks and tax advisory firms who explained how the NID could be used for group finance companies and treasury centres, for acquisition structures, and for post-acquisition restructuring.⁸⁷ Subsequently, many MNEs moved their corporate treasury centres to Belgium.⁸⁸

It is important to recognise the context to these statements. Even though the official tax rate has fallen over 7% in 3 years, the effective tax rate at the time was over 21% higher than the EU average, as noted in the explanatory materials.⁸⁹ The extrinsic materials also indicate that parliamentarians made reference to the Forbes suggestion that Belgium had the 3rd highest marginal tax rate in the world; cited as support for the proposition that Belgium's tax rates were high and corporate investment and economic stimulus was in need of bolstering (taking into account considerations of economics and taxation). Further, the parliamentary debates refer to the high unemployment rate as an economic problem with NID presented as a strategy to lowering corporate tax and giving the Belgian economy a new impetus⁹⁰.

Budgetary issues generally tend to pose one of the most significant political hurdles to implementing fundamental tax reform. Even though the budgetary cost of the NID was a significant issue, the government mentioned that it expected a €58M return on the NID reform.⁹¹ This was despite the revenue cost of €566M, which was largely accepted by parliament, with budgetary compensation measures and savings provisions (including abolishing corporate tax credits and opting-in to NID at the expense of opting-out of "investment reserve" provisions) amounting to €400M. The extrinsic materials make reference to the following 10-point benefits of the NID, anticipating that the NID would incentivise equity finance thereby encouraging investment; facilitate employment; stimulate financing; reduce bankruptcy risk thereby improving credit ratings; anchor investments in Belgium thereby reducing relocation risk; stimulate the establishment of new companies; ensure consistency with EU guidelines thereby providing the necessary legal certainty; facilitating an attractive investment climate; improve competitiveness of Belgium;⁹² and facilitate private corporations' investment in construction and property through equity finance.⁹³

⁸⁶ Quaghebeur, above n 73.

⁸⁷ Quaghebeur, above n 73.

⁸⁸ Quaghebeur M, 'Belgium Removes Obstacles to Risk Capital Deduction', Document 2005-24008; available at: <http://taxbites.be.apache05.hostbasket.com/taxation/pdf/t063.pdf>.

⁸⁹ *Chambre des Représentants en Belgique*, above n 77, Paragraph 15.20, 62.

⁹⁰ *Chambre des Représentants en Belgique*, above n 77, Paragraph 15.19-15.20, 60–61.

⁹¹ *Chambre des Représentants en Belgique*, above n 77, Paragraph 15.01, 53.

⁹² *Chambre des Représentants en Belgique*, above n 77, Paragraph 15.02, 55.

⁹³ *Chambre des Représentants en Belgique*, above n 77, Paragraph 15.02, 59.

The parliamentary debates highlight the criticisms in the design of the NID. For example, one of the major obstacles to the implementation of NID was contained in Article 9; which barred companies from distributing the portion of their profits that corresponds to the NID deduction by way of a dividend unless they retained an amount equal to the amount of the NID deduction for a period of at least four years. In the extrinsic materials prepared in June 2005, one of the key anti-abuse mechanism contained in Article 9 was reduced to 3 years following concerns that 4 years would make equity less appealing than debt finance and could undermine the effectiveness of the NID. Even though the design was the subject of passionate political debate⁹⁴ and was ultimately a compromise, the parliament considered that Article 9 should be further relaxed in subsequent legislative amendments.⁹⁵ Nonetheless, this provision was amended even before the commencement date of the NID; with the Belgian Prime Minister Guy Verhofstadt delivering a public announcement on 17 November 2005 that this obstacle to the NID would be lifted.⁹⁶ While this revision arguably aligned the NID more closely to its theoretical underpinnings in the ACE, it is largely an administrative issue rather than one of tax policy design which encourages the use of equity financing at the risk of making the system more vulnerable to abuse from aggressive tax planning. The key criticism was that the NID was largely agreed to in principle, but the provisions and administrative aspects were unnecessary to the point that it was criticised as largely missing its objectives in practice.⁹⁷ This highlights how translating ACE theory into practice through a robust tax reform design is one of its most challenging aspects, as anticipated by the wider ACE literature⁹⁸ and as experienced by jurisdictions in the past.⁹⁹ Separately, there was political opposition to the limited scope of the NID, which some parliamentarians argued ought to be extended to personal income tax.¹⁰⁰ This reflects the ACE literature, which anticipates that one key challenge in designing and implementing ACE reform is that it does not operate as a backstop to the personal income tax system.¹⁰¹ Even though leading commentators have suggested that tax neutrality cannot be achieved unless there is a personal level

⁹⁴ Parliamentary reports show dialogue such as “*Mr. Bogaert, I suggest that you take the sequel to the market stand, because you are very good at selling apples that look like pears.*” *Chambre des Représentants en Belgique*, above n 77, Paragraph 15.02, 57.

⁹⁵ *Chambre des Représentants en Belgique*, above n 77, Paragraph 15.52, 69.

⁹⁶ Quaghebeur, above n 88.

⁹⁷ *Chambre des Représentants en Belgique*, above n 77, Paragraph 15.20, 64.

⁹⁸ Isaac J, ‘A Comment on the Viability of the Allowance for Corporate Equity’ (1997) 18(3) *Fiscal Studies*, Institute for Fiscal Studies 303.

⁹⁹ The ACE-variant adopted in Brazil is more akin to a system of dividend deductibility; see further, Klemm , above n 35, 24.

¹⁰⁰ *Chambre des Représentants en Belgique*, above n 77, Paragraph 15.11, 58.

¹⁰¹ OECD, *Reforming Corporate Income Tax* (2008) OECD Observer: Policy Brief, Paris.

ACE,¹⁰² the domestic shareholder position is less relevant in a small, open economy where the marginal investor is likely to be a foreign investor.¹⁰³ While it is difficult to pinpoint the non-resident investor as the marginal investor, it is plausible for a small, open economy like Belgium.¹⁰⁴

2 Belgian NID: Subsequent amendments & economic, political and administrative issues

The NID has been continually amended by the Belgian parliament since its introduction in 2005, culminating in the continued reduction in the NID rate and the abolition of carry-forwards further limiting the scope of the NID. These two legislative changes have taken the NID further away from its original legislative purpose and underlying ACE principles. First, reducing the tax deduction provided for equity financing risks eliminating the neutrality properties of the ACE and simply providing a sweetener for equity financing,¹⁰⁵ and second, abolishing carry-forwards exacerbates the asymmetric treatment of profits and losses.¹⁰⁶

However, when considering any subsequent legislative amendments to the NID reform, a holistic understanding of the political landscape is an imperative starting point. Since 2007, Belgium was confronted by an ongoing political crisis at federal level.¹⁰⁷ During that time, the outgoing conservative/socialist government continued to handle current affairs, and in October 2007, following much political pressure, decided to conduct an investigation into alleged abuses by Belgian companies and Belgian banks of the NID.¹⁰⁸

A key political issue in practice is that the NID is thought to benefit the larger MNEs more so than SMEs. This is because the larger MNEs are able to put substantial amounts of equity capital into their

¹⁰² OECD, *Fundamental Reform of Corporate Income Tax*, OECD Tax Policy Studies No 16 (OECD Publishing, 2007), 88, 139.

¹⁰³ The Australian Government, The Business Tax Working Group, *Discussion Paper*, August 2012, available at: http://www.treasury.gov.au/~media/Treasury/Consultations%20and%20Reviews/2012/Business%20tax%20reform/Downloads/PDF/BTWG_discussion_paper_2012.ashx, 21.

¹⁰⁴ Belgium has been recently described as a small, open economy by economists; see, for example, Du Caju P, Rycx F and Tojerow I, 'Wage structure effects of international trade in a small open economy: the case of Belgium' (2012) 148(2) *Review of World Economics* 297.

¹⁰⁵ The Mirrlees Review recommend that the normal rate of return be utilized; see further, Auerbach, Devereux and Simpson, above n 60; and, Griffith R, Hines JR and Sørensen PB, *International Capital Taxation*, Chapter prepared for *Reforming the Tax System for the 21st Century: The Mirrlees Review* (2010) University of Copenhagen.

¹⁰⁶ Bond SR and Devereux MP, 'On the design of a neutral business tax under uncertainty' (1995) 58(1) *Journal of Public Economics*, Elsevier 57–71.

¹⁰⁷ Hooghe M, 'The Political Crisis in Belgium (2007-2011): A Federal system without Federal loyalty' (2012) 48(1) *Representation* 131.

¹⁰⁸ Quaghebeur, above n 73.

treasury arms or internal finance companies thereby eroding their corporate tax base.¹⁰⁹ This challenges whether the NID is genuinely beneficial for the domestic economy or whether it presents a tax break for the most profitable MNEs who are able to tax plan and bypass anti-avoidance rules and maintain very low effective tax rates. However, leading practitioners and economists observe that the NID also benefits SMEs by incentivising business capitalisation and thereby protecting businesses during the GFC.¹¹⁰ Further, it is arguable that this is an obvious feature of the NID which is why it was such an attractive investment reform to begin with. Some legal practitioners have observed that “*the purpose of introducing the notional interest deduction was just to make Belgium fiscally attractive to foreign investors and to offer a credible and competitive alternative for the coordination centres whose system was condemned by the European authorities*”.¹¹¹ Indeed, it is arguable that since the NID resulted in substantial investment by both local and overseas MNEs, it thereby encouraged a larger capital base, which ensured that those companies were well-positioned to withstand the GFC because of their capital buffers.

Nonetheless, the pressure from lobby groups and media sentiment that MNEs were unfairly advantaged by the NID remains substantial. By way of background, SMEs and MNEs currently have an average tax rate of approximately 34% and 5% respectively. This has resulted in industry lobby groups such as Le Syndicat des Indépendants & des PME calling for reform to the NID to “*reconcile the existing blatant discrimination between hundreds of small SMEs that pay 3-4 times more taxes than multinational companies*”.¹¹²

The following example demonstrates how MNEs were able to dramatically lower their tax bases; a MNE will establish an internal bank in Belgium and will then provide inter-company loans. If the NID deduction is, for example, 3% and the interest rate charged by the MNE on its inter-company loan is 3.5%, then corporate tax on the finance company’s net interest income is reduced to 0.5%.¹¹³

Political concerns regarding aggressive tax planning led to the broadening of Belgium’s thin capitalisation rule, which specifically targets inter-company loans with a 5:1 debt to equity ratio

¹⁰⁹ Projet de Loi-Programme, Chambre des Représentants de Belgique, 24 February 2012, Doc 53 2081/001, 95, available at: <http://www.lachambre.be/FLWB/pdf/53/2081/53K2081001.pdf>.

¹¹⁰ F-X G, ‘Renforcer le système des intérêts notionnels’, *L’avenir* (online), 2 February 2013, available at: http://www.lavenir.net/article/detail.aspx?articleid=DMF20130202_00263523.

¹¹¹ Themelin N, ‘The only consequence of the announcement effects of notional interest: the legal uncertainty’, Afshrift, 19 September 2013, available at: http://www.afschrift.be/en/the-only-consequence-of-the-announcement-effects-of-notional-interest-the-legal-uncertainty.html?cmp_id=8&news_id=2325.

¹¹² ‘Intérêts notionnels: le SDI plaide pour un système plus "fair-play"’, *Le Soir* (online), 5 July 2013, available at: <http://www.lesoir.be/275803/article/actualite/fil-info/fil-info-belgique/2013-07-05/interets-notionnels-sdi-plaide-pour-un-systeme-plus-fair-play>, translation mine.

¹¹³ This highlights that the use of intra-group finance companies poses key technical issues for ACE-based reforms in this area, and will be a significant aspect of future research by the author.

limitation. Further, subsequent explanatory notes¹¹⁴ reveal a link between the reduced scope of the NID and the increased incidence of thin capitalisation rules in Belgium. The relationship between reducing the scope of the ACE-variant and the increased implementation of thin capitalisation rules in Belgium suggests an inversely proportional relationship between these two reforms which has not been addressed in the English-language literature. Future research by the author will explore this aspect in further detail.

This presents arguably the most substantial hurdle to implementing and sustaining ACE-based reform; it is politically very difficult to quantify (and therefore justify) the benefit of the NID and very easy to point to the loss of revenue; for example, in Belgium €3–4 billion is claimed in NID deductions annually. However, in an increasingly globalising economy with capital mobility there is no certainty that regulatory tightening will prevent a loss of revenue. Belgium's thin capitalisation rules are relatively lenient. Even so, many MNEs are now moving out of Belgium as a result of the overall regulatory tightening including *inter alia* tightening thin capitalisation rules, increasing interest withholding tax rates, tightening anti-abuse rules and levying CGT on shares.

So, even though MNEs were subject to relatively low effective tax rates under the NID reform it is conceivable that this at least incentivised businesses to operate from, and develop in, Belgium – this influx in inbound investment may have, in turn, had a multiplier effect.

Nonetheless, the most significant political pressure point and media criticism of Belgium's NID is in relation to its cross-border impact; specifically, the tax avoidance opportunities that it presents for MNEs. However, policymakers are unable to deliver targeted reform in the cross-border context due to EU anti-discrimination law. This exemplifies the impact that politics has on tax policy developments and practice, most recently culminating in the European Court of Justice determining on 4 July 2013 that the NID rules and in particular the refusal to apply the NID to a foreign permanent establishments' net assets violates the freedom of establishment.¹¹⁵ It goes without saying that this resulted in the Council of Ministers resolving to amend the legislative provisions within 3 months of the judgment of the European Court of Justice.

Over the past few years, there has been increased media pressure and pressure from all sides of politics to abolish the NID. This resulted in the NID becoming a “hot topic” at the 2014 Federal election.¹¹⁶

¹¹⁴ La Chambre des représentants de Belgique – Belgische Kamer van volksvertegenwoordigers [Senate Explanatory Notes], *Project de Loi-Programme du 24 février 2012 – Ontwerp van Programmawet van 24 februari 2012* (n° 53-2081/001), Art 139, 94–98 (Belgium).

¹¹⁵ *Argenta Spaarbank NV* (C-350/11) case law of the European Court of Justice of 4 July 2013.

¹¹⁶ Themelin, above n 111.

Media reports indicated that political parties such as the Christian democratic party *Centre démocrate humaniste* ('CDH') promised to abolish the NID as part of their election campaigns:¹¹⁷

"The gain for public finances would be reinvested without waiting for the new term in a decrease of 10 per cent of the corporate tax rate, benefiting all, whether SMEs, TPE or independent ... This reform that we can carry out without delay ... deleting a liberal but also socialist mismanagement ... Notional interest for everybody, right now: SME, SOHO and independent."

It goes without saying that the tax policy uncertainty from first implementing, then modifying, phasing down, and now considering the abolition of the NID erodes business confidence. Leading practitioners agree that abolishing the NID will diminish the attractiveness of Belgium as a destination for inbound investment:

*"It is therefore true that the notional interest deduction has allowed many companies to reduce their taxable result, but that is precisely the goal that is pursued, with full knowledge of the facts, by the political parties that were at the origin of the construction and of which some criticize the construction heavily today ... This constant legal uncertainty incites some companies to seek calmer climes, sometimes by establishing themselves at just a few miles from our borders, this to the detriment of competitiveness, the economy and the image of Belgium on the international stage. This is of course regrettable."*¹¹⁸

The fate of the Belgian NID remains unclear, with the reform surviving the 2014 Federal election despite talks of its abolition. Meanwhile ACE-variants have been the subject of other European governments' reviews of comprehensive corporate taxation reform options, with Switzerland characterising their potential ACE-variant also as a 'notional interest deduction'.¹¹⁹

¹¹⁷ Belga, 'Le cdH veut supprimer les intérêts notionnels pour baisser sans attendre l'impôt', *Le Vif* (online), 31 August 2013; available at: <http://www.levif.be/info/actualite/belgique/le-cdh-veut-supprimer-les-interets-notionnels-pour-baisser-sans-attendre-l-impot/article-4000387901382.htm>, translation mine.

¹¹⁸ Themelin, above n 111.

¹¹⁹ Regarding Switzerland, see: PwC, 'The impact of Swiss Corporate Tax Reform III (CTR III)' (Position paper of PwC Switzerland, May 2015); the Swiss Federal Council recently removed the NID measure from the CTR III reform package. PwC opines that it ought to be reintroduced in the course of the parliamentary debate. See also, for example, in relation to Sweden: Linklaters, 'Proposed new tax regime for cost of capital' (12 June 2014); available at: <http://www.linklaters.com/News/LatestNews/2014/Pages/Proposed-new-tax-regime-cost-capital.aspx>.

C *Italy's ACE-variant*

Prior to 1997, the Italian corporate income tax system, which was designed as a full imputation system,¹²⁰ had not been subject to major reforms for nearly three decades. However, by 2004, Italy transitioned from an imputation system to a classical system, with a participation exemption regime introduced to mitigate double taxation of corporate profits.¹²¹ Italy's move away from an imputation system is in line with many other EU member countries.

Italy provides a unique and interesting case study because it implemented two ACE-variants under two different corporate-shareholder tax systems. First, the ACE-variant operating in Italy from 1998–2001 termed the Dual Income Tax ('DIT'). Although inspired by the Nordic DIT, Italy's DIT was very different as it only affected capital income. This has leading commentators describing it as "*the most confusing name*".¹²² Companies were liable to pay the statutory corporate income tax rate on above-normal profits; with the normal return on capital subject to a reduced tax rate fixed by the government; a nominal return on capital calculated by reference to the average interest rate on bonds plus a risk premium.

Second, the new ACE implemented in 2012, termed the Aiuto alla Crescita Economica ('Italian ACE'). Leading commentators observe that the Italian ACE shares the main characteristics of the theoretical ACE.¹²³ The Italian tax system also has elements of CBIT due to the local business tax, the IRAP, and also because of the limit to the deductibility of interest, in force since 2008. Accordingly, the Italian corporate income tax system can be characterised as combination of a partial ACE and a partial CBIT, thereby mitigating the debt-equity distortion from both directions.

1 *Italian DIT: Political hurdles to implementation*

An understanding of Italy's political dynamics is imperative in assessing tax policy reforms. Originating from a context of taxpayer discontent and widespread tax planning and tax evasion, the

¹²⁰ Lammersen L and Schwager R, *The Effective Tax Burden of Companies in European Regions: An International Comparison, Volume 28 of ZEW Economic Studies* (Springer, 2006), 75.

¹²¹ "Effective for tax periods starting on or after 1 January 2004, Italy applies a classical system of taxation of corporate profits. The former imputation system is abolished and replaced by a 95% participation exemption for corporate shareholders and a 60% exemption for individual shareholders who hold the participation in a business capacity. Individual shareholders not holding the participation in a business capacity are also entitled to the 60% exemption if they own more than 2% of the voting power or 5% of the capital in listed companies, or more than 20% of the voting power or 25% of the capital in other companies (substantial participation). Otherwise, dividends derived by individuals are subject to a final withholding tax at a rate of 12.5%."; see further, Uricchio A, *Italian Individual Taxation*, available at: www.lex.uniba.it/ta/ITALIAN_INDIVIDUAL_TAXATION.ppt.

¹²² Klemm, above n 35, 7.

¹²³ Caiumi A, Di Biagio L and Rinaldi, 'Corporation Tax in Italy: Evidence from tax return data', available at: https://editorialexpress.com/cgi-bin/conference/download.cgi?db_name=IIPF69&paper_id=460.

then centre-left government introduced the DIT as part of its “Visco” reforms. The relevant extrinsic materials detail the DIT was introduced to encourage greater neutrality in corporate financing decisions and facilitate competitiveness by making Italian an attractive investment destination.¹²⁴

2 Italian DIT: Subsequent amendments & economic, political and administrative issues

Revenue neutrality concerns resulted in two key restrictions being placed on the original DIT which reduced its initial effectiveness.¹²⁵ First, the opportunity cost of equity finance was not deductible from taxable income, rather it was taxed at a reduced rate; and second, only post-reform equity is considered in DIT deduction calculations under an incremental approach (similarly to the Belgian NID).

While leading academics observed that over time, the second restriction would not be problematic in the long-term, the short-term political repercussions were significant. The DIT was criticised as largely benefiting large and profitable firms, who were more likely to issue new equity, while companies in the South and SMEs were less likely to issue equity, despite their higher cost of debt.¹²⁶ This runs contrary to ACE theory, which anticipates that the ACE would increase the tax burdens on the most profitable firms and encourage innovation by SMEs by lowering tax burden on marginal projects.

One of the key legislative amendments that aligned the DIT more closely to the original ACE was the recognition by parliament that both personal and corporate income tax may need to be reformed in tandem to prevent inefficiencies in the type of organisational form. This culminated in the reorganization of the personal income tax in order to facilitate the capitalisation of companies.

In any event, it is arguable that the technical and social teething process suggests that the transition to the DIT had not been completed, with Senate stenographic report indicating:¹²⁷

“We have also further strengthened the tools to support new investments, through the extension and improvement of the Visco reforms, and the extension and acceleration of the Dual Income Tax ... its complexity both from a technical point of view and from a social impact, required a long preparation ... 2000, therefore, should reap the benefits of this long

¹²⁴ Bernardi L, ‘Some issues on the Italian tax reforms and the European tax environment: Introductory remarks’, *Società Italiana di Economia Pubblica*, Working Paper No 457, September 2005.

¹²⁵ Staderini A, Tax reforms to influence corporate financial policy: The case of the Italian business tax reform of 1997-98, Banca D’Italia Working Paper No 423, November 2001.

¹²⁶ Santoro A, ‘Ex-post evaluation of tax reforms: the case of the Italian Partial Ace’, 2005 (unpublished: University of Milano-Biocca).

¹²⁷ Senate Public Meeting 702a, Stenographic Report, 3 November 1999, 5-6; available at: http://www.senato.it/japp/bgt/showdoc/frame.jsp?tipodoc=Resaula&leg=13&id=00005402&part=doc_dc-allegatob_rs:1-gentit_dcdddl4236e4237-intervento_giaretta&parse=no&stampa=si&toc=no.

preparatory phase.”

The DIT was a restricted version of the standard ACE, subject to “*an excess of changes*”¹²⁸ and complicated interactions with other taxes, resulting in leading academics observing that this rendered both theoretical and empirical analysis difficult.¹²⁹

It is noteworthy that this reform package was not fully completed due to the change of the government’s coalition following elections in 2001, which resulted in the repeal of the DIT in favour of a single-rate corporate tax scheme. Leading commentators have observed that, interestingly, the abolition of the DIT resulted in a higher tax burden for most companies.¹³⁰ Further, administrative issues surrounding the continued ‘reform of the reform’ resulted in a detrimental level of uncertainty which stunted growth, with leading commentators highlighting the “*need for stability and completion of reforms for greater coherence and rationality of the system*”.¹³¹

3 Italian ACE: Political hurdles to implementation

Parliamentary transcripts provide detailed insights into the political spectrum and background rationales for why the Italian ACE was implemented in the midst of a recession.¹³² Specifically, parliamentarians from centrist parties observed in the explanatory materials that “*today’s speakers’ clearly witness the change in the political phase, which led to the opening of scenarios that seemed unthinkable just a few months ago*”.¹³³ There is specific reference to fact that the new reforms such as the Italian ACE are “*owing to the heterogeneity of the coalition forces supporting it ... the Decree-Law is only justified in light of this particular political and institutional framework*”.¹³⁴

This political solidarity culminating in the legislative reform under pressure of a “very dangerous”

¹²⁸ Bosi P and Guerra MC, ‘Lezione 1: Scienza delle finanze II – CLEP’, 2006, available at: http://www.google.com.au/url?sa=t&rct=j&q=&esrc=s&source=web&cd=3&cad=rja&ved=0CDwQFjAC&url=http%3A%2F%2Fwww2.dse.unibo.it%2Fgiannini%2FLezioni%2520a.a.%25202005-06%2FScienza%2520delle%2520finanze%2520II%2FSFII%2520-%25201%2520Introduzione.ppt&ei=rXrBUpKTF83jkAWYo4DIAQ&usg=AFQjCNEJg25-1V7jY1uLWH1Odep3hoyMA&sig2=yoybLX_g0kc7fpDYWzBMA&bvm=bv.58187178,d.dGI.

¹²⁹ Klemm, above n 35, 6–9.

¹³⁰ Oropallo F and Parisi V, ‘Will Italy’s Tax Reform Reduce The Corporate Tax Burden? A Microsimulation Analysis’ (2005) SIEP Working Paper No 403, Pavia.

¹³¹ Bosi and Guerra, above n 128.

¹³² International Monetary Fund, ‘Italy: 2013 Article IV Consultation’, IMF Country Report No 13/298, September 2013; available at: <http://www.imf.org/external/pubs/ft/scr/2013/cr13298.pdf>.

¹³³ The Referral - Commissions V and VI Finance, Budget and Treasury; Examination and Referral, 8 December 2011, 68; available at: http://translate.googleusercontent.com/translate_c?act=url&depth=1&hl=en&ie=UTF8&prev=t&rurl=translate.google.com.au&sl=auto&tl=en&u=http://documenti.camera.it/leg16/resoconti/commissioni/bollettini/html/2011/12/08/0506/comunic.htm&usg=ALkJrhgaCPDv5kkzf9KDiH88kWjR8JErnA#data.20111208.com0506.bolletti.no.sede00010.tit00010, translation mine.

¹³⁴ Commissions V and VI Finance, Budget and Treasury, above n 133, 5.

economic situation appears to have resulted in a renewed confidence in the Italian financial markets; “the political stability provided by the new government has had a positive impact on the financial markets with a reduction in the order of 200 points on the yield spread between Italian government bonds and German ones”.¹³⁵

The Italian ACE¹³⁶ was introduced to stimulate the capitalisation of companies by reducing tax on income from capital funding risk; reduce the imbalance in the tax treatment between companies that are financed with debt and companies that are financed with equity, thereby strengthening the capital structure of Italian companies; and to encourage, more generally, the growth of the Italian economy.¹³⁷

However, the Italian ACE was not implemented without political opposition. Parliamentarians from opposition parties such as Il Popolo della Libertà (Christian democrat party launched by Silvio Berlusconi) commented that the national and international press were talking about the Italian situation in alarmist terms and observed that “real growth in Italy is likely to be negative for a long time”.¹³⁸ The Italian ACE was also strongly opposed by regionalist minority parties such as Lega Nord Piemont, who believed that this reform would further depress growth, especially in their electoral areas in the North.¹³⁹

As originally drafted, Italian ACE invokes the DIT in some respects. A substantial improvement on the Italian ACE is that, while the DIT incentivised capitalisation by applying a reduced rate to the portion of profit identified by the notional return on capital, the Italian ACE provides a tax deduction in respect of the notional return on new equity. Further, the Italian ACE was introduced with retroactive effect, or to also apply for the whole of 2011. This ensured the Italian ACE was more closely aligned to the original ACE principles,¹⁴⁰ directly and immediately allowing deductions for equity financing and not providing an upper limit to the increases in equity financing.¹⁴¹ Importantly, the Italian ACE also applies to corporations, individual firms and limited partnerships, the inclusion

¹³⁵ Commissions V and VI Finance, Budget and Treasury, above n 133, 75.

¹³⁶ Decree-Law December 6, 2011, n. 201, containing urgent measures for growth, equity and consolidation of the public finances; Law 214/2011 (22 December 2011) and Decree by the Ministry of Economy and Finance dated 14 March 2012; presented by the Government on 5 December 2011; official gazette 19 March 2012.

¹³⁷ Cortellazzo & Soatto, ‘Aiuto alla Crescita Economica (ACE): incentivo alla patrimonializzazione delle imprese’ (2012) 13(1) *C & D Informa*, available at: <http://www.cortellazzo-soatto.it/Approfondimenti/TemieContributi/AiutoallaCrescitaEconomicaACEincentivoall.aspx>.

¹³⁸ Commissions V and VI Finance, Budget and Treasury, above n 133, 63.

¹³⁹ Commissions V and VI Finance, Budget and Treasury, above n 133, 75.

¹⁴⁰ See further, IFS Capital Taxes Group 1991 ‘Equity for Companies: A Corporation Tax for the 1990s’, *IFS Commentary No. 26*, Institute for Fiscal Studies, London.

¹⁴¹ Cortellazzo & Soatto, above n 137.

of which promotes neutrality in organisational form.¹⁴²

4 Italian ACE: Subsequent amendments & economic, political and administrative issues

While the Italian ACE is still in a relatively early stage, commentators praise the reform as a comprehensive package consistent with preventing MNEs from under-capitalising their Italian operations.¹⁴³ Indeed, the introduction of the Italian ACE has not led to the modification of Italian rules on the deductibility of interest. Currently interest barrier rules are in place instead of thin capitalisation rules, whereby the limitation of interest deductibility is now based on an operating income test, rather than debt-to-equity ratios.

An equally promising development was announced in October 2013, with the government releasing a list of measures it intends to implement to make Italy more attractive for foreign investors and to strengthen business conditions. Most relevant is Measure 19, which proposes the introduction of the “super ACE”, which targets companies intending to go public. Although there is currently little detail surrounding this proposal, the government has announced that the “*approach would be the same used in the current ACE, which enhances a company’s cost-effectiveness and ‘transparency’ after listing*”.¹⁴⁴ It will be very interesting to observe whether this reform is implemented and, if so, whether in practice it more closely aligns the Italian ACE to the original ACE principles.

Operationally, the new benefit results in a deduction from the total income of an amount corresponding to the notional return of new equity. This return, for the first three years of application of the rule (2011-2013) is fixed at 3%; however, from the fourth tax year (2014), this rate is determined by decree of the Minister of Economy and Finance to be issued by January 31 of each year, taking into account the average financial returns of public bonds, which may be increased by a further percentage point to more closely align with the risk-free nominal return (10-year Italian government bonds are currently returning approximately 4%, down from 6.5% in 2012).¹⁴⁵ Accordingly, 2015 is an interesting year for observing the developments to the Italian ACE, especially following the emergence of media reports since mid-December 2013 that the Italian political situation

¹⁴² See further, Panteghini P, Parisi ML and Pighetti F, ‘Italy’s ACE Tax and Its Effect on a Firm’s Leverage’, Discussion Paper No 2012-31, 2 June 2012, available at: <http://www.economics-ejournal.org/economics/discussionpapers/2012-31>.

¹⁴³ Assonime, ‘La disciplina dell’ACE (aiuto alla crescita economica)’ (Direct Taxation, Circular No 17, 7 June 2012).

¹⁴⁴ The Italian Government, ‘Destinazione Italia: A Plan to Attract Foreign Direct Investment in Italy’, 19 September 2013, available at: <http://destinazioneitalia.gov.it/wp-content/uploads/2013/10/destinazioneitaliaEnglishVersion.pdf>, 18.

¹⁴⁵ Cortellazzo & Soatto, above n 137.

is once again heading towards political uncertainty.¹⁴⁶

IV OPTIMISATION MODELLING: DO HOME JURISDICTIONS BENEFIT FROM CORPORATE TAX CUTS?

This section IV introduces the model used to simulate a tax-minimising multinational enterprise's (MNE's) behavioural responses. It also expands the literature by simulating cross-border intercompany tax planning strategies in responses to both current and proposed tax laws; in particular, the existence (and abolition) of ACE-variants and reductions to CIT rates.

A *Developing the Multinational Tax Planning ('MTP') model*

In an increasingly globalising economy with capital mobility, a lack of transparency makes it very difficult to observe how an MNE structures its internal affairs in a tax-optimal manner. This gives policymakers little information on the size and scope of the problem, which in turn makes targeting tax-minimisation techniques even more challenging.¹⁴⁷ Given the importance of tax revenue base protection, this presents a particularly pressing issue for capital importing jurisdictions such as Australia.

However, previous research by the author observes that the challenge presented by this 'invisibility' of cross-border intercompany transactions may be bypassed by conceptualising MNEs' funding decisions as a linear optimisation problem.¹⁴⁸ Specifically, the Multinational Tax Planning model ('the MTP model') was introduced by the author in previous research.¹⁴⁹ The MTP model utilises linear programming to simulate the cross-border intercompany tax planning responses of an MNE to both existing and proposed tax regimes.

¹⁴⁶ On 11 December 2013, Italy's then prime minister, Enrico Letta sought "a renewed vote of confidence from parliament, he vowed to fight ... for the survival of his government and its programme of political and economic reform." see further, 'Heading off the populists: Enrico Letta is fighting for the survival of his government', *The Economist* (online), 14 December 2013, available at: <http://www.economist.com/news/europe/21591644-enrico-letta-fighting-survival-his-government-heading-populists>.

¹⁴⁷ Markle K S and Shackleford D A, 'Cross-Country Comparisons of the Effects of Leverage, Intangible Assets, and Tax Havens on Corporate Income Taxes' (2012) 65(3) *Tax Law Review* 415, 417–432.

¹⁴⁸ Kayis-Kumar A, 'International Tax Planning by Multinationals: Simulating a Tax-Minimising Intercompany Response to the OECD's Recommendation on BEPS Action 4' (2016) 31(2) *Australian Tax Forum* 363.

¹⁴⁹ Kayis-Kumar, above n 148; see also, Kayis-Kumar A, 'What's BEPS Got to Do with It? Exploring the Effectiveness of Thin Capitalisation Rules' (2016) 14(2) *eJournal of Tax Research* (forthcoming).

Even though the literature suggests that international tax planning decisions can be approximated as an optimisation problem,¹⁵⁰ the use of mathematical optimisation remains largely unexplored in the international tax planning context.

Yet mathematical optimisation is one of the most powerful and widely-used quantitative techniques for making optimal decisions. It is possible to utilise mathematical optimisation in the international tax planning context by formulating the tax minimisation objective (described as the ‘objective function’, ‘Z’), which is determined based on the relationship between the ‘decision variables’ (denoted as ‘ x_1 ’, etc below) and the ‘cost’ to be optimised (whether through minimisation or maximisation, where $c_1, c_2, \dots c_n$ are constants).

This can be expressed as follows:¹⁵¹

$$\textit{Minimise (or Maximise): } Z = c_1x_1 + c_2x_2 + \dots + c_nx_n$$

Once the objective function has been formulated, the ‘constraints’ – which set out the limitations – need to be determined. Applied in the context of observing how an MNE may structure its internal affairs in a tax-minimising manner, the linear programming problem expresses the ‘objective function’ as minimising the total tax payable for the MNE. The ‘decision variables’ represents the profit in each jurisdiction in which the MNE has a subsidiary and the ‘constants’ are those respective jurisdictions’ corporate income tax rates.

Further, given the focus of this paper is on ‘pure’ profit shifting by a tax-minimising MNE through intercompany financing, the ‘constraints’ consist of, first, the flows from intercompany transactions that can increase or decrease the profit figures for each jurisdiction (the ‘primary constraints’), and second, the tax laws applicable to the MNE, which can be fine-tuned to particular jurisdictions’ specific tax rules (the ‘secondary constraints’).

Previous work by the author has focussed on detailing the the tax-minimising behavioural responses of MNEs based on changes in various interest limitation rules. This paper builds on previous research by simulating a tax-minimising MNE’s behavioural responses to changes in both interest limitation rules and reductions to corporate income tax rates.

¹⁵⁰ Brada J and Buus T, ‘Detection of Possible Tax-Evasive Transfer Pricing in Multinational Enterprises’ (2009) 4(2) *European Financial and Accounting Journal* 65; see also, Vasarhelyi M A and Moon D, ‘Optimizing Tax Allocation among Countries in the Multinational Entity: A Tale of Many Contingencies’ (Presentation delivered at the TTN Taxation Seminar New York 2011, Morgan Lewis Bockius LLP, New York, 16 May 2011), 6.

¹⁵¹ Iyer P S, *Operations Research* (Tata McGraw-Hill, 2008), 3.

B *The impact of corporate tax cuts in Belgium and Italy*

In an increasingly globalising and internationally competitive business environment, governments are under considerable pressure to lower their headline CIT rates. Belgium and Italy are no exception and there has been much political pressure to lower their CIT headline rates.¹⁵² The justification is that Belgium and Italy will be able to collect more tax revenue by being more regionally and internationally competitive. However, it is important to conceded that the economic rent portion of funds may escape tax.

This model's ability to isolate and observe the behaviour of pure profits facilitates an objective assessment of whether, *ceteris paribus*, a reduced CIT headline rate in Belgium or Italy can benefit the home jurisdiction, using the change in Total Tax Payable ('TTP') as proxy for this measure. The proxy for MNE tax-aggressiveness is when the Net Profit Before Tax ('NPBT') booked in the home jurisdiction (either Belgium or Italy) is between 0–20.

In relation to the Belgian subsidiary, even if the ACE-variant is abolished the TTP falls only marginally. Upon the implementation of CIT rate cuts the TTP falls again only marginally for the most tax-aggressive MNEs to a flat 49.40, which is an Effective Tax Rate of 24.7% (that is, 49.40/200).

On the other hand, for the Italian subsidiary even upon abolition of the ACE-variant the tax revenue base is protected by the existence of the Italian fixed ratio rule. In relation to CIT rate cuts, the TTP remains at 55.51 (an ETR of 27.8%) for the majority of increments of tax-aggressiveness until a reduction in the Italian CIT rate to 25.1%. From that point onwards there is no longer an additional incentive for profit shifting behaviour and TTP falls to a flat 50.20 (an ETR of 25.1%) for all levels of tax-aggression, as shown in the below Table 2.

However, an unintended consequence is that for the relatively less tax-aggressive MNEs a reduction in the CIT rate in place of an ACE-variant results in significantly lower TTP, as illustrated in Figure 1. In other words, if Belgium and Italy were to abolish their ACE-variants and instead synchronise their CIT rate cuts with the US then a reduction in their CIT rates to below 24.7% and 25.1% respectively would simply forfeit tax revenue from economic rents.

¹⁵² Belgium's 33% headline corporate income tax rate is the third highest in the EU region, and has been the subject of budget talks and deals: Martens J, 'Belgium Puts Corporate Tax Rate Under Review in Budget Deal' *Bloomberg* (15 October 2016); available at: <https://www.bloomberg.com/news/articles/2016-10-15/belgium-puts-corporate-tax-rate-under-review-in-budget-deal>. On the other hand, Italy, the 2017 Budget approved on 15 October 2016 is set to reduce the headline rate from 27.5% to 24%: Politi J, 'Italy's Renzi unveils spending plans in 2017 budget' *Financial Times* (16 October 2016); available at: <https://www.ft.com/content/473a99b0-9336-11e6-a80e-bcd69f323a8b>.

Specifically, where these variations are modelled with NPBT increments between 0–100, the ETR ranges between 25.2%–32.3% and 27.8%–29.5% for Belgium and Italy respectively, thereby simply enabling relatively less tax-aggressive MNEs to further reduce their TTP. This is shown in Table 2 as follows:

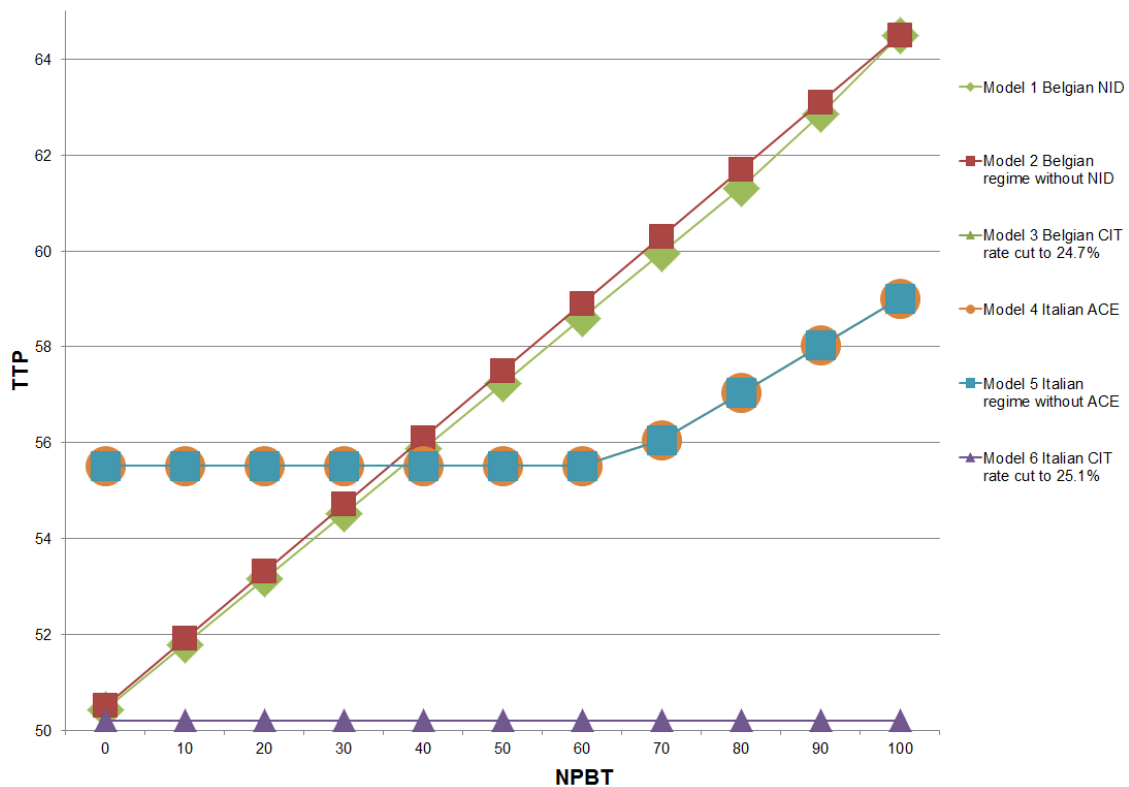
Table 2 – Results of modelling a headline CIT rate cut on the Belgian and Italian subsidiaries

<i>NPBT</i>	<i>Model 1 Belgian NID</i>	<i>Model 2 Belgian regime without NID</i>	<i>Model 3 Belgian CIT rate cut to 24.7%</i>	<i>Model 4 Italian ACE</i>	<i>Model 5 Italian regime without ACE</i>	<i>Model 6 Italian CIT rate cut to 25.1%</i>
<i>0</i>	<i>50.43</i>	<i>50.50</i>	<i>49.40</i>	<i>55.51</i>	<i>55.51</i>	<i>50.20</i>
<i>10</i>	<i>51.79</i>	<i>51.90</i>	<i>49.40</i>	<i>55.51</i>	<i>55.51</i>	<i>50.20</i>
<i>20</i>	<i>53.15</i>	<i>53.30</i>	<i>49.40</i>	<i>55.51</i>	<i>55.51</i>	<i>50.20</i>
<i>30</i>	<i>54.51</i>	<i>54.70</i>	<i>49.40</i>	<i>55.51</i>	<i>55.51</i>	<i>50.20</i>
<i>40</i>	<i>55.87</i>	<i>56.10</i>	<i>49.40</i>	<i>55.51</i>	<i>55.51</i>	<i>50.20</i>
<i>50</i>	<i>57.23</i>	<i>57.50</i>	<i>49.40</i>	<i>55.51</i>	<i>55.51</i>	<i>50.20</i>
<i>60</i>	<i>58.59</i>	<i>58.90</i>	<i>49.40</i>	<i>55.51</i>	<i>55.51</i>	<i>50.20</i>
<i>70</i>	<i>59.95</i>	<i>60.30</i>	<i>49.40</i>	<i>56.05</i>	<i>56.05</i>	<i>50.20</i>
<i>80</i>	<i>61.31</i>	<i>61.70</i>	<i>49.40</i>	<i>57.03</i>	<i>57.03</i>	<i>50.20</i>
<i>90</i>	<i>62.85</i>	<i>63.10</i>	<i>49.40</i>	<i>58.02</i>	<i>58.02</i>	<i>50.20</i>
<i>100</i>	<i>64.50</i>	<i>64.50</i>	<i>49.40</i>	<i>59.00</i>	<i>59.00</i>	<i>50.20</i>

Further, assuming that immobile economic rents will also be taxed at a reduced rate, the findings of this study suggest that a reduction in the CIT rate significantly below 25% will result in: at best, no difference in the tax benefit; and at worst, a reduced tax benefit to the home jurisdictions.

It should be noted that this study does not attempt to model investment behaviour over time in response to global tax changes. Rather, it observes that pure profits do not shift and economic rents are forfeited from a CIT rate reduction in place of an ACE-variant under both the Belgian and Italian regimes. Further, these results also suggest that a combination of an ACE-variant combined with a mechanism similar to a fixed ratio rule may present a more effective tax revenue base protection measure. This is the subject of further research by the author.

Figure 1 – Results of modelling a headline CIT rate cut on the Belgian and Italian subsidiaries



From a game theory perspective, tax competition issues cannot be eliminated. However, the findings of this model question whether jurisdictions such as Belgium and Italy would benefit from coordinated multilateral changes to CIT rates. This model assumes that coordination would only occur between higher-tax jurisdictions; that is, the Belgian and Italian subsidiaries, and the US. The findings are that, while TTP behaves in the way illustrated by the above Figure 1, the most tax-aggressive MNE never nominates to place any NPBT into the Belgian and Italian subsidiaries. This indicates that Belgium and Italy would not be the ‘winners’ from a coordinated multilateral CIT cut.

V CONCLUSION

One understudied aspect of the extensive literature exploring MNEs’ aggressive tax planning behaviour is that the normative framework of free market capitalism appears to justify this behaviour. The oft-cited efficiency argument has been utilised by MNEs to justify their use tax havens. *Ceteris paribus*, economic distortions are likely to increase incentives for tax-induced behaviours; in particular, aggressive tax planning. This paper approaches the extensive literature exploring MNEs’ aggressive tax planning behaviour from a novel perspective by exploring the tension commonly

experienced by policymakers between lowering the headline CIT rate as opposed to implementing economic rent taxes, thereby examining the extent to which free market capitalist policies may have influenced the implementation (or lack thereof) of ACE-variants.

In doing so, this paper identifies four key recurring trade-offs that present political challenges to the implementation of ACE-variants throughout its analysis of the Belgian and Italian experiences. These trade-offs are themes anticipated in the ACE literature. First, the trade-off between revenue neutrality and ACE system integrity. Second, the trade-off between implementing an ACE (at the expense of tax revenue) as opposed to reducing the headline corporate income tax rate. Third, on a domestic level, that politically the ACE is perceived to benefit MNEs disproportionately more so than SMEs. Fourth, on an international level, that there is a trade-off between the desire to make inbound investment more attractive and the risk of base erosion from aggressive tax planning by MNEs.

Ongoing research by the author consists of combining policy and legal analysis to develop a novel proposal for taxing cross-border intercompany economic rents.