1

Taxation of Corporate Income When Derived

Some of the primary features of a corporate tax system involve a corporation deriving income. The fact that a corporation can derive income stems from its separate legal *personality*. A corporation is a 'person' and can make profits from its contracts and dealings just as an individual can. Therefore, income tax laws that refer to 'person' and make liable to tax the 'person receiving or entitled to the income' or 'profits' automatically make corporations taxable with respect to their income.[1] The concept of 'person' is discussed further at 1.1.1.1.

However, just because corporations have, own or derive income as a legal fact does not mean that a tax law must respect the corporation's separate legal identity for tax purposes. A tax law, for its purposes, may override the corporate law prescription that a corporation is a *person* and ignore the separate legal personality of the corporation. Similarly, just because the law does not imbue an entity with separate legal personality does not mean that a tax law may not treat that entity as having and deriving its own income. In identifying entities that are the subject of a corporate tax system, a tax law may be both broader and narrower than the entities that are imbued with separate personality by law. The identification of entities that are the subject of the corporate tax system is discussed in section 1.1.[2]

[1] For example, ITTOIA 2005 (UK) ss. 8, 271 and 689. As discussed in Section 1.3.1, the vast majority of corporations in the UK are subject to corporation tax instead of income tax by reason of CTA 2009 (UK) s. 3. German Income Tax Law makes a distinction between 'physical persons' and 'corporations, unincorporated organizations and trusts'; for example, EStG (Germany) s. 1 and KStG (Germany) s. 1, respectively. Similarly, US tax law distinguishes between 'individuals' and 'corporations'; IRC (US) Parts I and II. China applies its IITL to 'individuals'; Art. 1. The EITL applies to 'enterprises and other organisations which have incomes', but 'sole individual proprietorship enterprises and partnership enterprises' are specifically excluded; Art. 1.

[2] For simplicity purposes and unless stated otherwise, this book presumes that entities identified as the subjects of a corporate tax system are corporations.

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Section 1.2 proceeds to consider the calculation of income or profits derived by a corporation for tax purposes. As mentioned in the introduction, only retained profits are considered at this stage and the membership structure (shareholding) is presumed to be static. General issues that arise with respect to the calculation of the income tax base are not issues that are specific to corporations, and these types of issue are not considered. Rather, the focus is on special issues raised for the tax base by reason of the nature of the corporation or the way in which it is regulated.

Like tax law, corporate law also requires corporations to calculate their profits and regulates the way this is done. The purposes for which corporations calculate profits under corporate law and tax law are not the same or at least are not perfectly aligned. So, a primary issue for a tax law is whether and to what extent it accepts and follows corporate law rules for calculation of profits. This is the first matter discussed in section 1.2. Similarly, corporate law generally prescribes reporting of profits for corporate groups. While this reporting is nearly always relevant for tax purposes, few countries, if any, simply follow financial reporting in determining the corporation tax base. Corporate groups raise particular issues for a corporate tax system, and these are discussed at appropriate points throughout this book. Section 1.2 also considers special tax base issues raised by corporate groups.

A further difficulty arising by reason of the existence of corporations is the interface between the tax base used for corporations and that used for individuals. This is particularly an issue for small or closely held corporations, and the interface becomes obvious and acute when an individual seeks to incorporate a business. While the immediate consequences of incorporation are considered in Chapter 4, section 1.2 considers interface issues that pertain to the tax base, that is, to what extent the personal and corporation tax bases should be aligned, at least for closely held corporations.

Once a tax law has identified a corporation and prescribed the calculation of its income or profits, the tax law must proceed to prescribe the tax treatment of those profits. The taxation of retained profits of corporations is a particularly contentious issue. This is discussed in Section 1.3. Corporate tax systems typically tax corporations with respect to their income. In this case, the primary issue is the selection of a corporate tax rate. There is no such thing as a 'correct' corporate tax rate, but there are factors that may inform a selection, and there may be consequences arising from a selection. These are pursued in section 1.3.1.

Just because a tax law recognises that a corporation has income does not mean that the tax law prescribes taxation of the corporation with respect

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to its income. Rather, it may prescribe that another person is taxable with respect to income retained by a corporation, typically the shareholders, but this is not the only possibility. So finally, the chapter considers the *transparent* taxation of a corporation's retained profits. This is not the same as ignoring or disregarding the existence of the corporation. It is still the corporation's income; it is just that another person is taxed with respect thereto.

1.1 Identifying and Classifying Corporations

An income tax law must identify the types of 'entity', from a range of possibilities, which are the subject of its corporate tax system. 'Entity' has numerous meanings. In tax laws it tends to be used in the sense of a being or body, something having a quality of individual existence as opposed to the 'qualities or relations' of the thing. In particular, an individual is an entity. In tax laws, other entities tend to have some form of relationship with, but can be perceived as independent of, individuals and their activities. These other entities are necessarily artificial in nature and constitute intermediaries through which individuals conduct activities. Of further relevance is 'body', which may be defined in terms of an 'entity; a thing which exists'. A body is that which 'either doeth or suffereth', and this seems of particular relevance in identifying entities for income tax law purposes.[3]

The US income tax law is quite direct in identifying entities subject to it. The IRC focuses income tax law obligations on 'taxpayers', which is defined by reference to 'persons'.[4] 'Person', in turn, is defined to 'mean and include an individual, a trust, estate, partnership, association, company or corporation'.[5] These are the potential range of tax subjects in the US. The IRC proceeds to define some of these entities, including 'partnership' and 'corporation', though not 'trust', 'estate', 'association' or 'company'.[6] 'Association' is particularly slippery and also used in the definition of 'corporation', discussed below at 1.1.1.1.

The German income tax laws also refer to 'taxpayer' in many places. However, the Income Tax Law only applies to 'physical persons', and so, in principle, only individuals are 'taxpayers'.[7] Nevertheless, the Corporate

[3] *Oxford English Dictionary* (2000–), definitions of 'entity', 'being', 'thing' and 'body'.
[4] IRC (US) s. 7701(a)(14).
[5] IRC (US) s. 7701(a)(1).
[6] IRC (US) s. 7701(a)(2) and (3).
[7] In particular, EStG (Germany) s. 1.

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Income Tax Law applies many provisions of the Income Tax Law, and so, indirectly, non-individual taxpayers are often covered by the latter.[8] So there is no definition of 'person' or 'entity' under German income tax law. Rather, there are physical persons and entities subject to corporate income tax. The latter is largely determined according to available commercial law entities, a matter further discussed below at 1.1.1.1. As noted at that point, German income tax law also grapples with the concept of 'unincorporated organisations'.

Chinese income tax law does not use the concept of 'person' or 'entity'. The Individual Income Tax Law (IITL) only applies to 'individuals'. By contrast, the Enterprise Income Tax Law (EITL) applies to 'enterprises and other organisations' but specifically excludes individuals conducting an enterprise and partnerships established under Chinese law.[9] This means that foreign-established sole proprietorships and partnerships may be subject to Enterprise Income Tax. There is no overarching definition of 'organisation', which seems to leave the tax administration with substantial latitude when interpreting that term.[10]

The position in the UK is comparatively a mess. UK income tax laws use the word 'entity' in numerous places but without definition. These uses suggest that an individual is not an 'entity', but that a company or corporation is.[11] Perhaps a trust is an 'entity', even an entity independent of its trustees, but this matter is not settled. Contrast the Australian income tax law, where a comprehensive definition of 'entity' expressly includes individuals, corporations, partnerships, associations, bodies of persons and trusts.[12] So like US law, Australian law uses a concept to identify the range of subjects to which tax law obligations may affix and then uses that concept consistently, but the concept is labelled 'entity', whereas the US uses 'person'. By comparison, the UK has little structure to its approach, which is fragmented and confusing.[13]

As in the US, the primary term used in the UK to identify the subject of tax law obligations is 'person'. However, this term is not defined

[8] KStG (Germany) ss. 8(1) and 31.

[9] EITL (China) Art. 1. Enterprise Income Tax Regulations ('EITR') (China) Art. 2 limits the exclusion for sole proprietorships and partnerships to those established under Chinese law.

[10] In contrast to most countries, in China the power of interpreting laws in China rests with the legislative and administrative bodies and not the Chinese courts; see Arnold, Ault & Cooper (2019, 67).

[11] See ITA 2007 (UK) s. 997, CTA 2010 (UK) s. 1127 and TIOPA 2010 (UK) s. 340.

[12] Income Tax Assessment Act 1997 (Australia) s. 960–100.

[13] Generally, see Harris (2011).

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in UK income tax law, and its ordinary legal meaning suggests that it is limited to individuals and corporations. This meaning is extended by the Interpretation Act 1978 to include 'a body of persons corporate or unincorporate'.[14] 'Body of persons' is not defined in the Interpretation Act. Its ordinary meaning suggests it would cover all the types of entity referred to in US or Australian tax law, with the exclusion of individuals and maybe trusts (as opposed to trustees).[15]

Confusingly, while 'body of persons' is not defined in the Interpretation Act, it is defined in UK tax law to mean

> any body politic, corporate or collegiate and any company, fraternity, fellowship and society of persons whether corporate or not corporate…[16]

This definition incorporates a list of entities that dates back to the land tax and earlier subsidies beginning in 1450. The result is that where the UK income tax laws use the word 'person', a 'body of persons' according to its general meaning is included. Where those laws use the phrase 'body of persons', only its tax law definition is used. Further, for both income tax and corporation tax purposes, specific provisions provide that partnerships are not regarded as an entity separate from the partners (unless otherwise provided).[17] The situation is far from satisfactory.[18]

Having identified possible entities, a tax law must proceed to determine which of them constitute the subjects of its corporate tax system. The manner in which a tax law does this is discussed under section 1.1.1. However, just because a tax law identifies an entity as a 'corporation' and intends that all corporations should be the subjects of its corporate tax system does not mean that the tax law will treat all of those corporations in precisely the same manner. Invariably, tax laws go further and subcategorise the subjects of the corporate tax system. Section 1.1.2 discusses the ways in which corporations may be subcategorised for the purposes of a corporate tax system.

[14] Interpretation Act 1978 (UK) First Schedule.

[15] See Avery Jones (1991, 458–59). Particularly, Constable (2020, 12) notes that under this definition a partnership is a body of persons and so 'is a "person" in its own right'.

[16] ITA 2007 (UK) s. 989 and Taxes Management Act 1970 (UK) s. 118(1).

[17] ITTOIA 2005 s. 848 and CTA 2009 s. 1258.

[18] Generally, see Avery Jones (1991) and Harris (2011). By contrast, the Australian income tax law defines 'person' to include a 'company'. This might seem a rather limiting definition of 'person', but for the fact that 'company' is defined to include an 'unincorporated association or body of persons'; Income Tax Assessment Act 1997 (Australia) s. 960–100. The result seems to be similar to that in the UK but with no definition of 'body of persons' in the income tax law, thus avoiding the UK confusion.

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One manner in which corporations may be subcategorised is by reference to their owners and controllers. However, ownership and control of a corporation may call into question whether the corporation is an appropriate subject of the corporate tax system at all. So, categorisation of corporations by reference to their owners and controllers crosses the divide between recognition of tax subject and subcategory. For this reason, such categorisation is dealt with separately. Section 1.1.3 explores the relationship between a corporation and the persons that own or control it. Section 1.1.4 discusses how a corporate tax system may respond to various forms of this relationship. Section 1.1.5 considers how a corporation may be subcategorised by reference to its owners and controllers.

1.1.1 Identifying Corporations

As mentioned above, in selecting the subjects of a corporate tax system, most countries go beyond a literal meaning of 'corporation' and include some entities that do not have separate legal personality. Further, some tax laws exclude from their corporate tax system entities that are truly corporations. These tax law adjustments are often achieved through a definition of 'corporation' or 'company'. General definitional issues are the first matter dealt with in this section. Some tax laws have a habit of indirectly extending the definition, at least for particular purposes. These laws exclude certain entities from the general definition of 'corporation' but then proceed to treat them as corporations for identified purposes and sometimes generally. These *tack-on* regimes are the other matter dealt with in this section.

The importance of identifying entities as subjects of a corporate tax system should not be underestimated. Through this mechanism governments make policy decisions as to how individuals conducting their activities through different intermediaries should be taxed. Individuals conducting their activities through one form of entity that is within the definition are most often taxed differently from those conducting their activities directly or through another form of entity that is not within the definition. If these activities are similar and the different forms of entity are freely available, the tax system creates a distortion as to the use of one particular type of entity over another.[19] Tax law distortions favouring or disfavouring incorporation are a continuing theme of this book.

[19] Generally, see Crawford & Freedman (2010).

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1.1.1.1 Definition

Tax laws must identify the entities that are the subject of the corporate tax system. Tax laws of civil law jurisdictions often incorporate a list of entities subject to corporation tax in the charging provision. This is the approach under Germany's KStG.[20] Part One of that law continues to provide further details as to entities subject to the German corporate tax system. The approach in China is different. The EITL applies to 'enterprises', a term that is not defined in the EITL. However, other Chinese commercial laws provide that certain entities are 'enterprises'. For example, China's Companies Law provides that companies established under it are 'an enterprise legal person'.[21]

By contrast, the tax laws of common law jurisdictions tend to incorporate a general collective definition of entities the subject of their corporate tax system. The term used by common law jurisdictions is typically 'company' but sometimes 'corporation'. The use of 'company' seems to be for two reasons. First, the registered company is the most common form of corporation. Second, the legislature intends to cover many more entities than just corporations.

The UK corporate tax system applies to 'companies'. Section 992 of ITA 2007 provides that

> 'company' means any body corporate or unincorporated association, but does not include a partnership, a local authority or a local authority association.

The same definition is found in section 1121 of Corporation Tax Act (CTA) 2010. This definition was adopted in 1965 with the introduction of corporation tax. There is some argument that the definition was intended to cover all 'persons' that were not individuals or partnerships and so covers 'bodies of persons' as that phrase is used in the Interpretation Act 1978. This is the reason for the reference to 'body corporate' and 'unincorporated association', but the definition and, in particular, 'unincorporated association' have taken on its own meaning.[22]

This can be contrasted with the US approach, which provides a definition of 'corporation':

> The term 'corporation' includes associations, joint-stock companies, and insurance companies.[23]

[20] KStG (Germany) s. 1.
[21] Companies Law (China) Art. 3.
[22] Generally, see Harris (2011). Contrast the Australian definition of 'company', above at fn 18, which expressly includes both 'unincorporated associations' and 'bodies of persons'.
[23] IRC (US) s. 7701(a)(3).

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It should be noted that the UK's is a 'means' definition, and so 'company' does not have its ordinary meaning. By contrast, the US's is an 'includes' definition, and so 'corporation' takes its ordinary meaning and, in addition, is extended by the inclusions.

Corporations Corporate tax systems primarily focus on 'corporations', within the general law meaning of that term. This is clear in the UK reference to 'body corporate' (in the definition of 'company') and the US inclusive definition of 'corporation'. It is also clear in the German list approach, which includes the primary forms of 'corporation',[24] and residually 'other private law legal entities'.[25] 'Corporation' or 'body corporate' means an artificial entity that is imbued with personality by law.[26] Corporate status is most commonly achieved by statute, but incorporation may also be (largely historically) granted by charter or letters patent. The situation in China is more regulated due to the basic socialist public ownership principle of the economy entrenched in the Chinese Constitution, which prescribes 'public ownership of the means of production'.[27] Nevertheless, it is clear from the express exclusion of individual and partnership enterprises that the focus of the EITL is on entities with separate legal personality granted under the Company Law.

Separate legal personality means that corporations own their assets (both legally and beneficially) and are capable of having their own income at general law. The most common type of corporation is the registered company limited by shares. In many countries there are other types of corporation including companies limited by guarantee, unlimited companies, partnerships granted corporate personality and corporations set up under their own statute for special purposes. The range of corporate entities differs dramatically from country to country, for example, the range is quite narrow in China. The separate personality gives a corporate tax system a certain comfort with these types of entities. Outside of this heading, this book presumes a corporation is a registered company limited by shares.

[24] KStG (Germany) s. 1(1)1. Expressly included as corporations are Europäische Gesellschaften (European companies established under the *European Company Statute*, Council Regulation (EC) No 2157/2001), Aktiengesellschaften (stock corporations or AGs), Kommanditgesellschaften auf Aktien (limited partnerships with shares or KGaAs) and Gesellschaften mit beschränkter Haftung (limited liability companies or GmbHs).

[25] KStG (Germany) s. 1(1)4.

[26] Although matters are never that simple. See Montagu (2001) regarding the history and meaning of 'body corporate'.

[27] Chinese Constitution Art. 6.

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Unincorporated Entities Despite a primary focus on corporations, corporate tax systems also typically cover certain types of unincorporated entities. Which types of unincorporated entity are covered varies from country to country, and it is difficult to generalise, although partnerships are usually excluded in one way or another.

In the UK, the definition of 'company' includes 'unincorporated associations'. This acts as a form of residual entity category. Historically, the 'unincorporated' and 'association/society' elements of 'unincorporated association' were interpreted separately, as in the tax law definition of 'body of persons'. However, in the *Conservative and Unionist Central Office* case the Court of Appeal interpreted the two terms as a joint phrase.[28] The question was whether the investment income of the Central Office (of a political party) was subject to corporation tax or income tax, as these were imposed at different rates. It was assumed in this case that, if the Central Office was not assessed as an unincorporated association, the income would be assessed to income tax.[29]

In *Conservative and Unionist Central Office*, Lawton LJ defined an 'unincorporated association' in the following terms:

> I infer that by 'unincorporated association' in this context Parliament meant two or more persons bound together for one or more common purposes, not being business purposes, by mutual undertakings, each having mutual duties and obligations, in an organisation which has rules which identify in whom control of it and its funds rests and upon what terms and which can be joined or left at will. The bond of union between the members of an unincorporated association has to be contractual.[30]

The Central Office was not such an association, although clearly each individual constituency office would be.[31] The most common forms of unincorporated associations are clubs and trade associations. 'Unincorporated association' does not cover individuals or trusts (the latter two are discussed shortly), but whether it can cover a partnership seems an open issue. It seems HMRC does not accept Lawton LJ's position that an unincorporated association must be bound together for non-business purposes.[32]

[28] *Conservative and Unionist Central Office v. Burrell* (1981) 55 TC 671 (CA).

[29] In *Conservative and Unionist Central Office* v. *Burrell* (1981) 55 TC 671 (CA), presumably, the Central Office was a body of persons, a grouping of persons (singular including the plural) or a trust. This well demonstrates the confused nature of the UK entity structure and why entity classification matters.

[30] *Conservative and Unionist Central Office v. Burrell* (1981) 55 TC 671 (CA) at 699.

[31] For example, as in *Curtis* v. *Old Monkland Conservative Association* [1906] AC 86 (HL).

[32] HMRC, *Company Taxation Manual*, at [CTM41305], available at https://bit.ly/3Y6STbO, accessed 15 June 2023.

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One consequence of an association being unincorporated is that at law it does not own property and cannot contract. So, when including unincorporated entities, it might be expected that a corporate tax system would specify that such entities can own property and have income for tax purposes. Most often such a rule is not included, and that is the case in the UK. At least indirectly, this may have consequences. While not solely concerned with this issue of the unincorporated nature of certain associations, the issue of mutual trading is at least directly related to it. The question is whether the tax law recognises transactions between a member and their association such as to give rise to income of the association. Further consideration of mutual trading is beyond the scope of this book.[33]

In Germany as well, certain unincorporated entities are covered by the corporate tax system. In particular, the entities subject to corporation tax include 'associations, institutions, foundations and other special-purpose funds without legal personality under private law'.[34] These entities can include business entities and so, potentially, partnerships (but see below on exclusions). From 2022, general partnerships (*Offene Handelsgesellschaft*, OHG) and limited partnerships (*Kommanditgesellschaft*, KG) may elect to be treated like a corporation ('check-the-box').[35] In principle, all partners must agree to the election. The election may be reversed, in which case (as with the US check-the-box regime) it is treated as a change of legal form subject to the reorganisation rules discussed in Chapter 6. In China too, an unincorporated entity may be covered by the corporate tax system under the heading 'other organisations', and this may cover associations or cooperatives carrying on a business. As in Germany, while this might include partnerships, partnerships are subject to specific exclusion and the exclusion includes limited partnerships.

The US approach is also similar, with the definition of 'corporation' including 'association'. However, unlike the laws in China, Germany and the UK, US tax law contains no exclusions for particular types of unincorporated association, such as partnerships. Consequently, the US courts adopted a substance approach to 'association' as used in the definition of 'corporation'. In *Morrissey*, the US Supreme Court suggested that an organisation will be treated as an association if its characteristics are such that the organisation more nearly resembles a corporation than

[33] Generally, see Bramwell et al. (2009–, [A1.2]) and the references cited therein.
[34] KStG (Germany) s. 1(1)5.
[35] KStG (Germany) s. 1a. It is proposed to extend this to all partnerships.

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a partnership or trust.[36] Relevant corporate characteristics include such things as association (more than one person), objective to carry on business and divide the gains, continuity of life, centralisation of management, limited liability, free transferability of interests and holding title to property as an entity. These factors were reflected in a modified form in a list set out in Treasury Regulations on the definition of 'corporation' (now repealed).[37]

As a result, under US tax law, limited partnerships and some trusts may have found themselves being taxed as corporations, depending on their characteristics. The substance approach was problematic in itself, but the US States added to the problems by enacting LLC statutes.[38] These laws played on the federal list, trying to grant organisations as many corporate attributes as possible without resulting in classification as a corporation for US federal tax purposes.[39] From the start of 1997, the US tax administration gave up on this approach and adopted an elective regime known as the check-the-box regime. Under this regime many business entities, including limited liability companies, partnerships, trusts and sole traders, may elect whether to be treated as a corporation or transparent for tax purposes.[40]

Exclusions Sometimes entities are specifically excluded from a corporate tax regime. The German Corporate Income Tax Law provides an example. It lists the types of entity that are subject to corporation tax. As mentioned above, this might include a partnership. However, section 3(1) of the KStG goes on to provide that unincorporated associations are not subject to corporation tax if their income is subject to corporation tax or income tax 'directly through another taxpayer'. The Income Tax Law specifically provides that the income of partners from business includes their 'profit shares' from the partnership.[41] Civil law classification

[36] *Morrissey* v. *Commissioner* (1935) 296 US 344 (SC). In this case, a trust created to develop certain real estate was treated as a corporation for tax purposes.

[37] The so-called 'Kintner' regulations, for example see United States (2017, 8 at fn 23) and Taylor (2016, 18).

[38] Regarding the development of LLC statutes beginning with Wyoming in 1977, see Montagu (2016, 475) and Röder (2017, 24–25). Both note that the flood of LLCs began in the early 1990s and by 1996 all US States plus the District of Columbia had LLC statutes.

[39] United States (2017, 8 at fn 23) notes that LLCs effectively made entity classification 'elective for well-advised taxpayers'.

[40] See Title 26 Code of Federal Regulations (US) § 301.7701-1 and following. The election is not available for businesses incorporated under state laws, insurance companies, banks and state-owned corporations. The election is made by filing Form 8832.

[41] EStG (Germany) s. 15(1)2.

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applies for the purposes of determining what is a partnership. As a result, partnerships per se are not subject to corporation tax (but limited partnerships with shares are expressly covered). The check-the-box regime introduced for partnerships in 2022 specifically provides that upon election the partners are treated as 'non-personally liable' for tax on the partnership's income.[42] This disapplies the rule in the Income Tax Law and results in the partnership being liable for corporation tax as described above.

The approach in China is similar. A partnership established under the Chinese Partnership Law is an 'enterprise'.[43] In principle, this means partnerships would be subject to the EITL but for the fact that they are specifically excluded from the scope of that law.[44] As Chinese partnerships may only be established in China under the Partnership Law it is clear that the reference to 'partnership' in the EITL is a reference to entities established under the Partnership Law, including limited partnerships. An entity that is not expressly excluded from the scope of the EITL is a trust. However, it seems clear that a trust established under Chinese law is neither an 'enterprise' nor an 'organisation'. The Trust Law establishes that a trust is a 'relationship' and that trust property is 'obtained by the trustee'.[45]

As mentioned, the US definition of 'corporation' is an 'includes' definition and contains no express exclusions. The complex case law on whether a partnership or trust could be considered a 'corporation' was replaced from 1997 with the check-the-box regime. The check-the-box regime means that non-corporate business entities may elect out of the corporate tax system (just as they can elect into it).

By comparison, the UK approach is again messy and an explanation long-winded. In the UK the exclusion of partnerships (and trusts) from the corporate tax system is not based on their income being taxed to someone else or an election. Rather, in the UK 'partnerships' are expressly excluded from the definition of 'company'.[46] There is no useful definition

[42] KStG (Germany) s. 1a(1).

[43] The Partnership Law (China) applies to 'partnership enterprises' (Art. 1), a phrase that is defined in Art. 2.

[44] EITL (China) Art. 1.

[45] Trust Law (China) Arts 1 and 14, respectively. While this law does provide that an 'organization established in accordance with law' can be a settlor or beneficiary, a trust is not described as an organisation; Arts 19 and 43.

[46] Local authorities and local authority associations are also excluded. Regarding the origins of these exclusions, see Harris (2011).

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of 'partnership' or its counterpart 'firm' in the income tax laws.[47] Of more relevance is the definition in section 1 of the Partnership Act 1890:

> Partnership is the relation which subsists between persons carrying on a business in common with a view of profit.

It is clear that an association that is unincorporated and carries on a business is a partnership. Anti-intuitively, however, it seems that according to Lawton LJ's definition a partnership is not an 'unincorporated association' (see above discussion of 'Unincorporated Entities') where that phrase is used in the income tax law definition of 'company', because an 'unincorporated association' requires a non-business purpose. This may be inconsistent with the drafter's intention and the history of the definition.[48]

The Partnership Act definition goes on to exclude corporations from 'partnership'. Of particular importance, this means that, despite their origins as partnerships, companies registered under the Companies Act 2006 are not partnerships. Indeed, it seems that the exclusion in the definition of 'company' in the income tax laws must import the meaning of 'partnership' from the Partnership Act. Otherwise, it may be argued that registered companies are not 'companies' for tax purposes. The problem with importing the Partnership Act definition is that it only excludes corporations formed under UK law. This raises some difficult questions with respect to foreign entities, which are briefly discussed below (see heading on 'Foreign Entities').

Without more, the exclusion of 'partnerships' from the definition of 'company' also raises difficult issues with respect to limited liability partnerships registered under UK law. These entities appear to be and are called 'partnerships' but are given corporate personality by section 1 of the Limited Liability Partnership Act 2000. Therefore, it seems limited liability partnerships fall outside the definition of 'partnership' in the Partnership Act 1890. But would they be 'partnerships' for purposes of the exclusion in the definition of 'company' in the income tax laws? Sections 863(2) of ITTOIA 2005 and 1273(2) of CTA 2009 specify that references to 'partnership' in the Taxes Acts includes a reference to a 'limited liability partnership', and this would include the use of 'partnership'

[47] ITTOIA 2005 (UK) s. 847(1) and CTA 2009 (UK) s. 1257(1) describe 'persons carrying on a trade in partnership' as a 'firm', but that seems irrelevant for the purposes of the definition of 'company'.

[48] See Harris (2011). Lawton LJ's interpretation gives little scope for the statutory exclusion of general partnerships in the income tax law definition of 'company'. A consideration of the separate legal personality of Scottish partnerships is beyond the scope of this book.

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in the context of the definition of 'company'. Like 'partnership', however, 'limited liability partnership' is not defined and again this raises issues for foreign entities.[49]

In the UK trusts are not expressly excluded from the definition of 'company'. A trust is primarily an arrangement under which trustees hold property. A trust would not be an 'unincorporated association' according to Lawton LJ's definition in *Conservative and Unionist Central Office*, nor would the trustees as a group or the beneficiaries as a group be an unincorporated association.[50] This contrasts with the position under US case law where a trust could (if it has sufficient corporate characteristics) be characterised as an 'association' and so a corporation. It is also unlikely that a trust or its trustees or beneficiaries is a 'body of persons' as defined in the UK income tax laws (see text above at footnote 15); the closest phrase used in that definition appears to be 'society of persons'. It seems joint trustees are a 'body of persons' as used in the definition of 'person' in the Interpretation Act 1978, and perhaps the beneficiaries, and even the trustees and beneficiaries combined. Bringing the trust itself within that definition is more problematic.

Foreign Entities Income tax laws typically deal expressly with the types of entities formed under the law of the country in question.[51] Given the variety of foreign entities, it is very difficult for an income tax law to expressly deal with all types of foreign entity. Therefore, an income tax law usually has some general classification or characterisation rules to deal with foreign entities. There is more than one reason why an income tax law would do this, but for present purposes the issue is whether a particular foreign entity falls within the corporate tax system or not.

The immediate problem with foreign entities is that these are entities unknown to domestic law. Some countries recognise legal status granted by a foreign country, but in other countries, particularly common law countries, that is not necessarily the case. As expressed in one UK case:

> The position of a foreign company of any sort in this country is really anomalous. A foreign company is not recognised as a legal entity; there is no definition of or status given to a foreign company. It is only by the

[49] Contrast the position in China where the same Partnership Law provides for both general partnerships and limited partnerships; Partnership Law (China) Art. 2. This makes it clear that the EITL exclusion of partnerships applies to both types of partnership.

[50] In any case, profits derived by a company in a fiduciary capacity are not subject to corporation tax; CTA 2009 (UK) s. 6(1).

[51] Also see Harris (2020, 68–71).

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> comity of nations that we recognize that there are such things as companies which have an entity analogous to the incorporated company as we know it over here.[52]

There are three primary approaches available to the characterisation of foreign entities:

(i) classify foreign entities according to their closest domestic equivalent;
(ii) rely on foreign commercial law or foreign tax law classification; and
(iii) give the taxpayer a choice of separate taxpayer or transparent.

The first approach is the most common and is adopted by Germany and the UK. The third approach is largely adopted by the US. The Chinese approach is very broad but does not obviously fit within any of these three approaches. Common to all approaches is an attempt to fit foreign entities within the broad legislative structure outlined above.

Historically, German practice suggested that foreign entities could only fall within the residual category in the list as an 'unincorporated association'.[53] In determining whether a foreign entity is subject to the German corporate tax system, German courts use a comparative typology approach in order to ensure consistent treatment of German and foreign entities conducting similar activities.[54] For this purpose, a foreign entity is compared to German entities and classified according to German criteria. The treatment under the tax law where the foreign entity is established is irrelevant. This approach derives from the 1930 *Venezuela* decision.[55] This approach is clear in the 2004 Federal Ministry of Finance's special letter ruling on the classification of US LLCs for German tax purposes, which is accepted as generally applying to the classification of foreign entities.[56] In assessing whether a US LLC is a corporation or partnership for German tax purposes, the LLC is assessed according to criteria very similar to those formerly used in the US for determining whether a partnership was

[52] Lord Hanworth in *Ryall* v. *Du Bois* (1933) 18 TC 431 (CA) at 440. Also, see Lord Hanworth in *Dreyfus* v. *CIR* (1929) 14 TC 560 (CA) at 575–76.

[53] This has changed as a consequence of case law of the Court of Justice of the European Union ('CJEU') under which Germany must recognise the legal personality of foreign companies with their 'real seat' in Germany; Case C-208/00 *Überseering BV* v. *Nordic Construction Co Baumanagement GmbH* [2002] ECR I-9919 (CJEU). In 2006 amendments were made to KStG s. 1(1)1 to make it clear that foreign entities can qualify.

[54] Kahlenberg (2014, 156) refers to this as the 'Corporate Resemblance Test'.

[55] Decision of the Imperial Finance Court (Reichsfinanzhof) of 12 February 1930, VI A 899/27, RStBl.1930, 444.

[56] Federal Ministry of Finance (Bundesministerium der Finanzen), letter of March 19, 2004, BStBl.I 2004, 411. And see Kahlenberg (2014, 157).

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taxable as a corporation.[57] This means that while Germany adopts a form approach to the characterisation of domestic entities, it essentially adopts a substance approach to the characterisation of foreign entities. Since 2022, foreign partnerships can elect to be treated like corporations under the check-the-box regime, but only if they are subject to corporation tax in their country of residence.[58]

Turning to the UK definition of 'company', an initial question to ask is whether the foreign entity is granted a separate legal personality (i.e. is a 'body corporate') under the law of the country in which it is formed.[59] If a foreign entity is not a body corporate, it often will be an 'unincorporated association' as defined by Lawton LJ in *Conservative and Unionist Central Office*. Determining whether a foreign entity that falls within either of these two positive limbs is nevertheless excluded because it is a 'partnership' is more difficult. As mentioned, the definition in the Partnership Act 1890 is very broad and would include UK registered companies were it not for their specific exclusion. But that exclusion only extends to entities incorporated under UK law.

'Partnership' as used in the income tax law is not expressly defined, but it seems it should largely draw its meaning from the Partnership Act 1890 and the meaning in that Act could clearly cover a foreign entity.[60] The better view seems to be that 'partnership' as used in the tax law definition of 'company' must be read as excluding foreign entities analogous to those UK entities excluded from the definition of 'partnership' in the Partnership Act 1890.[61] So, foreign corporations, including registered companies, must be considered 'companies' for UK income tax purposes and not 'partnerships'. A similar problem arises with respect to foreign 'limited liability partnerships'. Again, that phrase is not defined in UK income tax law. Its meaning for tax purposes will be largely, but not

[57] See Eckhardt and Woywode (2004), Kahlenberg (2014) and Dorfmueller and Knoche (2021).

[58] KStG (Germany) s. 1a(1)2.

[59] For example, in *Memec plc* v. *IRC* [1998] STC 754 (CA) at 762 Peter Gibson LJ noted that a 'partnership is not a company [under UK income tax law] and it is an agreed fact that a silent partnership is not a body corporate under German law'. With reference to classifying US LLCs, Montagu (2016, 476–77) notes that 'the fact that an LLC is not referred to or described in the statute pursuant to which it is organised as a "body corporate" should deflect a UK court from applying UK tax law by reference to the substantive position of that LLC under the law of the state pursuant to which that LLC is organised'.

[60] That is, where the foreign entity could be considered to involve 'persons carrying on a business in common with a view of profit'; Partnership Act 1890 (UK) s. 1(1).

[61] That is, by Partnership Act 1890 (UK) s. 1(2).

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exclusively, drawn from the Limited Liability Partnerships Act 2000. In an analogous manner to the treatment of UK limited liability partnerships, it seems the better view is that foreign limited liability partnerships must be considered 'partnerships' for UK tax purposes and so excluded from the definition of 'company'.[62]

This is another messy area of UK income tax law, where foreign entities must be classified according to the UK boxes of 'body corporate', 'unincorporated association', 'partnership' and 'limited liability partnership'. Whether a foreign entity is a 'company' for UK tax purposes will be determined accordingly. In fitting foreign entities into these boxes the UK adopts a two-stage process:

(i) Ask what characteristics are given to the entity by the corporate or commercial law in the country of formation. The treatment or classification under the foreign *tax* law is generally irrelevant in this process.
(ii) Given those characteristics, ask which type of UK entity the foreign entity most similar to; for example, is it more like a partnership or a corporation?[63]

UK tax administration guidance largely focuses on whether a foreign business entity is transparent (like a partnership) or opaque (like a corporation). It lists six factors that are considered relevant. This list is similar, but not the same as, that formerly used by the US in determining whether an 'association' was a 'corporation'. The UK factors need to be weighed and balanced in order to properly characterise a foreign entity. The UK tax administration considers two factors particularly important. These are: whether the business is carried on by the entity or jointly by persons with an interest in the entity; and whether the persons with an interest in the entity are entitled to share in profits as they arise or whether they must wait for a decision to distribute the profits. The guidance includes a presumptive list characterising common foreign entities.[64]

Historically, the US took the classification of foreign entities further than in the UK. Foreign entities were all classified as unincorporated

[62] Contrast HMRC, *Partnership Manual*, at [PM131540], available at www.gov.uk/hmrc-internal-manuals/partnership-manual, accessed 15 June 2023. HMRC suggest that if the foreign limited liability partnership is a 'body corporate', it will be subject to corporation tax, but if it is 'regarded as a partnership' it is not. The suggestion seems to be that 'body corporate' and 'partnership' are mutually exclusive.

[63] And see Montagu (2016).

[64] See HMRC, *International Manual*, at [INTM180000], available at https://bit.ly/3KeyM5I, accessed 15 June 2023.

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associations (classification under the foreign law of organisation being irrelevant). This meant that foreign entities might only be a corporation for US tax purposes under the 'association' heading.[65] When the check-the-box regime was introduced in 1997, this meant all foreign entities would be corporations or transparent at their choice. Treasury Regulations establishing the check-the-box regime now contain a list of foreign entities that must be considered as corporations.[66] The list has grown substantially from its inception and typically includes the types of entity that may be listed on a foreign stock exchange, such as the Chinese joint-stock limited company, the German stock corporation (AG) and the UK public limited company.[67]

In China, all foreign enterprises or organisations are subject to the EITL. This is very broad and includes enterprises conducted by foreign individuals or partnerships.[68] The State Administration of Taxation ('SAT') interprets which foreign entities fall within 'enterprises' and 'organisations'.

1.1.1.2 Extensions

Common law jurisdictions often extend the meaning of 'corporation' or 'company' by treating some entities that do not fall within the general definition as though they did, at least for limited purposes. The UK provides an example of this approach with respect to authorised unit trusts. Unauthorised unit trusts are taxed as trusts. By contrast, the trustees of an authorised unit trust are treated for income tax purposes as a resident company, at least as regards income arising to the trustees. Similarly, the rights of unit holders are treated as shares.[69] While treated as companies, authorised unit trusts are subject to corporation tax at the basic income tax rate, rather than the usual corporate tax rates.[70]

A common rationale for extending the corporate tax system beyond 'corporation' or 'company' as defined is to cover entities that in substance behave like corporations. This rationale seems clear, for example, in the US treatment of publicly traded partnerships, which are treated as corporations for US tax purposes.[71] Australia seems to adopt the same rationale

[65] Internal Revenue Service Ruling 88-8, 1988-1 C.B. 403.
[66] Title 26 Code of Federal Regulations (US) § 301.7701-2(b).
[67] Regarding US classification of foreign entities, both before and after the introduction of the check-the-box regime, see Mullis (2011).
[68] EITR Art. 2. Regarding the inclusion of foreign-established partnerships, see Ting and Xiliang Ge (2014, 674).
[69] CTA 2010 (UK) s. 617.
[70] CTA 2010 (UK) s. 618.
[71] IRC (US) s. 7704.

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with respect to corporate limited partnerships and public trading trusts.[72] There may be some element of this in the UK treatment of authorised unit trusts, but the dominant rationale for the UK treatment seems to be to avoid trust tax consequences when a trust retains income.

From a policy perspective, this rationale is a serious matter. If an individual can achieve the same economic outcome by deriving income through a registered company or a limited liability partnership, shouldn't the tax consequences be the same in either case? If accepted and taken to the extreme, this would require a substance rather than a form approach to identifying the subjects of a corporate tax system, much in the same way as the US courts approached the definition of 'corporation' prior to the introduction of the check-the-box regime in 1997.

As mentioned, the factors that the US courts used to assess whether a non-corporate entity was a 'corporation' for tax purposes were similar to the corporate attributes discussed in any basic corporate law textbook. These include matters such as separate legal personality, separation of ownership and control, limited liability, continuous existence and free transferability of interests. Whether all or any of these criteria provide a sufficient justification for a different treatment of one entity when compared to another entity is a matter of debate. The US found this system very difficult to administer.

On balance, there seems some justification for basing the selection of entities for a corporate tax system on form with specific additions for cases of high similarity (such as with unit trusts and limited liability partnerships). This involves a pragmatic compromise between ease of administration and reducing tax-induced distortions as to one form of intermediary over another. This issue is returned to at various points in this book.

1.1.2 Classifying Corporations

Having identified the subjects of a corporate tax system, almost all tax laws go on to subcategorise these subjects in some fashion. As mentioned above, corporate tax systems do this because they do not treat all types of 'corporations' or 'companies' or dealings with or in them the same. There are only so many ways in which the subjects of a corporate tax system may be subcategorised. The options pertain to the fundamental features of a person. Persons may be subcategorised by reference to the time at which

[72] Income Tax Assessment Act 1936 (Australia) Part III Divisions 5A and 6C, respectively.

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they come into existence or cease to exist. Persons may be subcategorised by reference to their physical attributes. Corporations do not have physical attributes, but they do have a location or situs, at least by analogy with individuals. Persons may be subcategorised by reference to their relations with other persons. Persons may be subcategorised by reference to the assets they own or activities they conduct.

This section first considers subcategorising corporations by their relations with other persons, then by location or situs and then by activities. It does not consider subcategorising by other means such as by time of existence. The section is solely concerned with identifying subcategories. It is not concerned with the special rules that apply because corporations fall within a particular subcategory. Those special rules are considered at relevant points throughout this book.

1.1.2.1 Based on Relations

Individuals may be related to each other by blood or other recognised bond such as marriage, adoption or civil partnership. Artificial entities are not capable of such relations but do form other bonds. Artificial entities can be owned and controlled. These attributes are either irrelevant or repugnant in the context of individuals. The nature and degree of ownership and control of a corporation may impact on the types of rules applied by a corporate tax system with respect to a corporation. Ownership and control may also question whether the corporation is independently an appropriate subject of the corporate tax system.

In this way, ownership and control of corporations is not just a question of subcategorising the subjects of the corporate tax system, but also a question of identifying such subjects. It is an area where section 1.1.1 and 1.1.2 overlap and, for this reason, subcategorising corporations by reference to their ownership and control is dealt with separately. Section 1.1.3 explores the relationship between a corporation and the persons that own or control it. Section 1.1.4 considers potential responses to ownership and control of corporations. Section 1.1.5 then turns to categorising corporations by reference to their owners and controllers.

1.1.2.2 Based on Situs: Resident/Non-resident

Typically, a corporate tax system subcategorises corporations according to their location or situs. The location or situs of a corporation is usually determined by reference to the corporation's residence. Taxation based on corporate residence is an internationally accepted jurisdiction to tax. This is not a book about international taxation, but it does consider the

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extent to which international factors impact on a corporate tax system. Corporate tax systems adopt different rules depending on whether the subject corporation is resident or not. These are directly explored in Chapter 3. The definitional issue of corporate residence is briefly considered here.[73]

Corporate residence is just another area where UK tax rules have been adopted more by accident than by design. The original income tax of the Napoleonic Wars focused on individuals rather than corporations. As the registered company became common during the second part of the nineteenth century, UK courts applied the general wording of the income tax law to these companies, including the concept of residence. In 1906 in the *De Beers* case, the House of Lords finally rejected the argument that a corporation was resident in the country where it was incorporated or registered. Lord Loreburn stated:

> An individual may be of foreign nationality, and yet reside in the United Kingdom. So may a company. Otherwise it might have its chief seat of management and its centre of trading in England under the protection of English law, and yet escape the appropriate taxation by the simple expedient of being registered abroad and distributing its dividends abroad … [A] company resides for purposes of income tax where its real business is carried on … I regard that as the true rule, and the real business is carried on where the central management and control actually abides.[74]

The 'central management and control' test has been consistently applied in cases since *De Beers* and is commonly used for tax purposes in countries with common law based on the UK tradition. This central management and control test has come to focus on the highest level of decision making of the business of a corporation.

Civil law jurisdictions developed facts and circumstances management tests similar to the UK's test and this style of test eventually found its way into double tax treaties as a tiebreaker for dual resident corporations (although weakened from 2017).[75] Some countries, however, including the US, adopted the place of formation or incorporation as their test of residence. The US continues to apply a test purely based on whether the

[73] The following consideration relies heavily on Harris (2020, 74–80).

[74] *De Beers Consolidated Mines* v. *Howe* [1906] AC 455 (HL) at 458. It was part of the argument in the *De Beers* case that a foreign corporation (having no legal existence in the UK at the time) could not be resident in the UK and if it was resident anywhere it was the place of its incorporation.

[75] Particularly, through former Art. 4(3) of the Organisation for Economic Co-operation and Development's ('OECD') Model Convention on Income and Capital ('OECD Model').

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corporation is 'created or organized in the United States or under the law of the United States or any State…'[76] By contrast, the majority of countries began to apply dual tests for residence, one based on management and the other on formation, registration or incorporation.

Until 1988, the UK relied solely on the central management and control test. In that year the case law test was supplemented with an incorporation test. Section 14(1) of CTA 2009 states that '[a] company which is incorporated in the United Kingdom is UK resident…' This provision cannot apply to an unincorporated association. Section 15 of CTA 2009 is entitled 'Continuation of residence established under common law'. However, the content of the section does not say this, and, in any case, it is problematic applying the section to unincorporated associations. It must be presumed that the central management and control test continues to apply (and could apply to an unincorporated association). Why the legislation is left in this encrypted form is not clear.

By contrast, the German Corporate Income Tax Law subjects corporations 'to unlimited corporation tax liability if their business management or seat of operations is in the country…'[77] So a corporation is resident if it has its statutory seat or its management in Germany. A corporation's statutory seat is the place so designated in its charter, that is, the place where it is formally registered. A corporation organised under German law must specify a statutory seat in Germany and so this test operates in a manner similar to a place of incorporation test.[78] The Tax Code provides that 'management' of a business is the centre of commercial executive management of the business; that is, the centre from which the corporation's activities are directed.[79] The focus here is on the day-to-day management rather than the top level of management as in the UK.[80]

China also adopts a dual definition of residence of an enterprise. An enterprise is resident if it is 'set up under Chinese law' or if its 'establishment of effective management is within the territory of China'.[81] 'Establishment of effective management' is defined by reference to executing 'substantial

[76] IRC (US) s. 7701(a)(4) defining 'domestic' corporation.
[77] KStG (Germany) s. 1(1).
[78] AktG (Germany) s. 5. Also see Anzinger (2017, 3–4 and 23).
[79] Tax Code (*Abgabenordnung*) ('AO') (Germany) s. 10. Also see Anzinger (2017, 18–19).
[80] Regarding 'effective management' and the difference between it and 'central management and control' (if any), see Harris (2020, 85–87).
[81] EITL (China) Art. 2.

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and overall management and control over the manufacturing and business operations, personnel, accounting, properties, etc. of an enterprise'.[82] As in Germany, the focus is again on day-to-day management, with particular emphasis on the former OECD Model tiebreaker test.[83] A non-resident corporation may effectively elect to be treated as resident under a special administrative rule.[84]

1.1.2.3 Based on Activities: Size and Character

Corporations may also be subcategorised according to their earning activities. Like individuals, this may depend on the character of their activities. Relevant activities might include trade or business, investment, banking, insurance, agriculture, shipping, ownership of certain assets, etc. Some types of activities may be dominated by corporations and a corporate tax system may incorporate special rules for corporations engaged in specified activities. However, in principle, individuals may engage in any earning activity that a corporation may engage in. Therefore, sub-categorisation of corporations according to earning activity is not directly related to the inherent nature of a corporation and so specialised earning activities are not discussed in this book as discrete topics.

The same can be said of the size or scale of the activities conducted by corporations. Corporations are often subcategorised by reference to size, and a number of examples are noted throughout this book. Size can relate to a number of factors such as monetary value of turnover or assets or number of employees.[85]

[82] EITR (China) Art. 4.

[83] And see SAT Announcement [2009] No. 82 Art. 2 referring to where top managers perform their duties, whether financial decisions are approved by persons in China, location of property, administrative records, board meetings and shareholder meetings and residence of directors and top managers.

[84] SAT Announcement [2009] No. 82 Art. 7. Regarding tax planning involving this rule, see Wei Cui (2021, note 13).

[85] For example, to qualify for the lower rate in EITL (China) Art. 28 an enterprise must have taxable income not exceeding RMB 3 million, employees not exceeding 300 and assets not exceeding RMB 50 million; EITR (China) Art. 92. By contrast, in the EU 'enterprises' (including corporations) are categorised by reference to European Commission Recommendation 2003/361/EC. Under the recommendation, an enterprise is 'micro' if it has fewer than 10 employees and either turnover or assets of no more than €2 million. An enterprise is 'small' if it has fewer than 50 employees and either turnover or assets of no more than €10 million. An enterprise is 'medium' if it has fewer than 250 employees and either turnover not exceeding €50 million or assets not exceeding €443 million.

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1.1.3 Exploring Relations with Owners and Controllers

As mentioned above at 1.1.2.1, persons are often defined or subcategorised by reference to their relations with other persons. In the context of corporations, relations with their owners and controllers are particularly relevant. This section explores those relations. First it considers the nature of ownership and control of a corporation. Second, it considers the various degrees of ownership and control that persons may have in and over a corporation. Finally, it considers the situation where two or more corporations are owned and controlled by the same persons, that is, common ownership and control.

1.1.3.1 Nature of Ownership and Control

Corporations are artificial entities and cannot be or do without individuals. Like an individual, a corporation may act through its agents. However, the acts of an agent are performed on behalf of the principal and are not acts of the principal per se. A corporation exists (is embodied by) and acts through its organs. These organs are clear in the context of registered companies, the focus of the current discussion.

Registered companies typically have two main organs: the general meeting of shareholders and a board of directors or managers, although there may be subcategories of each depending on the corporation and the jurisdiction. The shareholders own the company and typically have three types of rights: they have the right to participate in the distribution of profits, they have the right to capital and any surplus should the company be wound up, and they have the right to vote in general meetings (see below at 2.1). By contrast, the board of directors is responsible for the day-to-day management of the company and members of the board are typically elected and removed by the general meeting.

A reference to the 'ownership' of a company is most directly a reference to rights to dividends and surplus, that is, a right to share in the economic performance of the company. So, two companies are commonly owned when the same persons have the same rights with respect to dividends and surplus in each of the companies.

A reference to 'control' of a company is most directly a reference to rights exercised by vote in general meeting in appointing directors (and making other constitutional changes) or by the directors in conducting the day-to-day affairs of the company.[86] There may be lower levels

[86] For example, see the discussion of the UK Court of Appeal in *Steele* v. *EVC International NV* [1996] STC 785 (CA) in holding that 'control' of a close company was to be tested at the shareholder level. See below at 1.1.5.2.

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of control, such as where the board properly delegates functions to a chief executive officer or managing director. Nevertheless, the board remains responsible for supervision of such delegates. A company is controlled by a person when the person has sufficient voting rights at general meetings of the company to pass relevant resolutions. A company is controlled at the board level typically by a majority of board members acting together.

1.1.3.2 Degrees of Ownership and Control

Ownership and control of a corporation are questions of degree, not absolutes. Ownership may range from complete ownership of the shares in a corporation to a fraction of a percent. Similarly, control may range from absolute control at one extreme to independence at the other. Nevertheless, it is common to speak of 'majority' ownership or 'control' in the sense of an ability to pass a resolution at general meeting or board level by majority. In a registered company structured along standard lines, a person who owns a majority of the shares has the right to appoint all members of the board of directors.[87] As a result, majority owners often have absolute control at the board level.[88] These types of corporations are referred to as 'controlled corporations'.

Many corporations are not owned or controlled by a single person. Where a corporation has a small number of shareholders, the shareholders are capable of acting collectively and as a result, the ownership and control of the corporation will tend to coincide. This is because, at the least, the shareholders can vote in a sufficiently coordinated manner so as to consciously control the directors through the power of appointment and removal. Often the shareholders have entrenched rights to be represented on the board of directors. Small corporations of this nature are often referred to as 'quasi-partnerships'. Quasi-partnerships and one-controller corporations are referred to as 'closely held corporations'.

This form of collective control becomes less practical as shareholding becomes more widely dispersed. Where shareholders are so dispersed that a majority is no longer capable of acting in a coordinated fashion, the

[87] In many civil law jurisdictions other stakeholders may have a right to be represented on the board.

[88] There will be corporate law restrictions on the extent of this absolute control. In particular, there is typically no control over a company's constitution without a special majority (e.g. 75 per cent of votes).

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ownership and control of the corporation is separated. The corporation is still owned by its shareholders, who have the right to profit distributions and surplus. But the shareholders do not have a practical method of exercising their votes so as to control the directors, who have a much greater degree of autonomy in widely held corporations.

This is not to say that shareholders in widely held corporations have no influence. Even in widely held corporations some shareholders may have a sufficient holding in the corporation to have some say in its management, for example, by appointment of a particular director. Such shareholders are often referred to as 'substantial shareholders'. Corporate law may grant substantial shareholders special rights, including rights to call general meetings and presentation and receipt of information with respect thereto.[89] As ownership and control coincide to some degree in substantial shareholders, a corporation and its substantial shareholders may be loosely referred to as 'associated'.

1.1.3.3 Common Ownership and Control of Corporations

A corporation owned and controlled by a particular individual can behave much as the alter ego of that individual. Ever since the introduction of the registered company, there has been no limit on the number of corporate alter egos a particular individual may have. If an individual registers, owns and controls a number of corporations, these corporations share a common bond. That common bond is in the form of their sharing a common ownership and control by the individual. In this sense, the corporations are 'related', and the familial metaphor is extended to refer to such corporations as 'sibling' corporations. The formation and ownership of a corporation by an individual creates a form of dual vision for a corporate tax system, which sees both the corporation and the individual. The formation and ownership of multiple corporations by an individual creates multi-vision.

Also, since the introduction of the registered company, it has been possible for one corporation to hold shares in and to own and control other corporations. This was a consequence of granting registered companies an independent identity, that is, corporate status. The ownership and control of multiple corporations by a single individual creates multi-vision for a corporate tax system. The ownership and control of corporations by other corporations creates multi-dimensional vision that can push

[89] For example, see Companies Law (China) Art. 110, AktG (Germany) ss. 122 and 124 and Companies Act 2006 (UK) ss. 303 and 338.

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the rationality of a corporate tax system to the extreme. The ownership and control of corporations by other corporations creates legal fictions (subsidiaries) within legal fictions (parent) and limited liability within limited liability.

However, the ownership of shares by one corporation in another corporation does not, of itself, mean that the corporations are related. As noted with respect to sibling corporations, this requires a common bond in the form of ownership and control. Where that ownership and control vests in another corporation, the familial metaphor is taken further, and the other corporation is said to be the 'parent'. The owned or controlled corporations are its 'subsidiaries'. Accordingly, subsidiaries are a form of controlled corporation and are a form of or subset of closely held corporation. Many of the issues that this book discusses in the context of closely held corporations are also discussed in the context of subsidiaries.

A parent corporation and its subsidiaries are a 'corporate group'. This is the typical meaning of 'corporate group', and it may extend to multiple depths, such as where there is a sub-parent or holding corporation. Single-dimensional sibling corporations may also be described as a corporate group (although less commonly), but the owning and controlling individuals are not part of that group (because they are not 'corporate').

It is for good reason that familial terminology is applied to corporate groups. Many, if not most, of the difficulties that a tax system faces with respect to corporate groups, the tax system faces with respect to families of individuals. The high level of ownership and control by a parent corporation causes a high level of integration between members of a corporate group. The result is that the members of a corporate group tend to act as a single economic unit. A family of individuals also tends to behave as a single economic unit. Members of either type of family (individuals or corporations) often behave to their detriment if they perceive that another member of the economic unit will receive a greater benefit than the detriment suffered. The result is a form of arbitrage, which is particularly problematic for tax systems.[90]

Further like families of individuals, at the fringes it can be difficult to determine which corporations are in the corporate family and which are

[90] Of course, the situation is deeper than either the corporate family or the family of individuals. Both of these types of families may integrate, and so a family of individuals and their closely held corporations may act as a single economic unit. Income tax laws often overlook this and incorporate multiple rules that deal with the same conceptual issue.

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not. In the context of individuals, some relatives are sufficiently remote that they are not viewed as part of the family or the 'immediate' family, although they might fall within a phrase such as 'extended' family. So, an individual might be a 'relative' and yet not a family 'member'. Similarly, two corporations might be 'related' and yet not part of the same corporate group, that is to say, not group members. This is likely to be the case where one corporation is a substantial shareholder in the other, that is, they are associated corporations, but a corporation's 'relatives' form a broader category.

A corporation is related to another person where there is sufficient ownership and control or sufficient common ownership and control to give rise to a risk that one will act to its detriment (or not fully exploit an opportunity) in order to benefit the other. So, a corporation is 'related' to persons (individuals or corporations) that have a substantial shareholding in it, that is, persons that have some degree of control or influence over the corporation through an ownership interest in the corporation. A corporation is also 'related' to other corporations that are owned and controlled by one of its substantial shareholders. 'Related corporations' and, with respect to a particular corporation, 'related individual' and 'related entity' are understood accordingly.

Labels such as 'controlled corporations', 'group corporations', 'closely held corporations', 'associated corporations' and the catch-all 'related corporations' are merely descriptions of something that can only be measured by factors of degree rather than absolutes. Nevertheless, these are labels and distinctions that are broadly used in many tax laws.

1.1.4 Responses to Concentrated Ownership and Control

Corporations where ownership and control coincide to any degree, that is, corporations that are related to their owners, raise challenging issues for corporate tax systems. How should a corporate tax system respond to these challenges? There are a number of options, each with advantages, but none without difficulties. Almost inevitably, a corporate tax system will adopt different options in different contexts, and so this book deals with implementation of those options at various points. However, the fundamental policy issue in all these contexts is how a corporate tax system should view or identify a corporation and its related entities. This is properly an issue for this section.

Before considering definitional issues, it is appropriate to consider the options that a corporate tax system has for identifying a corporation with

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its owners and controllers. There are three fundamental options in this regard. First, a corporate tax system may accept the general law approach that each corporation is a separate person that is to be taxed separately and incorporate no special rules for corporations and their relatives. This is the non-intervention approach, which accepts certain manipulative behaviour between a corporation and its relatives that naturally erodes the separate identity of the corporation.

Second and third, the corporate tax system may seek to directly intervene with special rules that either erode the separate identity of the corporation or reinforce its separateness from its relatives. Rules that erode the separate identity of a corporation may vary. At one extreme, the rules may collapse that identity completely, that is, consolidation of identity with that of the owners or controllers. At the other extreme, the rules may merely facilitate the transfer of certain tax attributes between the corporation and its relatives. Rules that reinforce the separateness of a corporation seek to prevent or ignore the natural behaviour between a corporation and its relatives that blurs the corporation's separate identity granted by corporate law. Each of these three options is considered in turn.

1.1.4.1 Non-intervention: Separate Entity Approach

An income tax system must base itself on the transactions and dealings recognised by law. It would be quite impossible for an income tax law to rewrite each and every transaction entered into by every person, and there would be little point in doing so. However, a tax system will intervene in certain behaviour and effectively rewrite it or prescribe specific consequences for tax purposes. The present question is whether it should do so in the context of corporations and their relatives. As noted above, it is of the nature of such corporations that they may behave to their individual detriment if they perceive that a related entity will receive a greater benefit from that behaviour than the detriment suffered.

This behaviour is caused by concentration of ownership and control of the corporation in specific persons and is particularly acute in controlled corporations, such as group corporations. The income tax system faces similar issues with families of individuals. The fundamental question for an income tax system, including its corporate tax system, is how strictly it wishes to enforce the selection of tax subject it has adopted. An income tax is a direct tax that allocates income to persons and taxes them according to their personal circumstances. If the income tax system has adopted the individual and the individual corporation as its

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tax subjects, how strictly should it seek a 'proper' allocation of income between individuals or corporations and their relatives?

The core of the issue can be demonstrated by reference to group corporations. Group corporations are subject to a high level of common ownership and control and behave like a single economic unit. If the tax system recognises the legal fiction of each group member rather than the economic reality, group corporations will and do manipulate relations between themselves so as to produce the lowest tax result. As a rule of thumb, in a closed economy, this means averaging out the tax liability between each group member, presuming they are taxable at the same rates. If they are not taxable at the same rates, then the group corporations can be expected to move tax consequences to the members with the least exposure to tax.[91] The same manipulative behaviour exists between families of individuals and between individuals and their controlled corporations and other artificial entities.

The point is that, despite being imbued with separate legal personality by corporate law, controlled corporations do not behave separately from an economic perspective.[92] Corporate law does little to address this disconnect. It will commonly prescribe that the board of directors of each corporation, whether in a group or otherwise, should act loyally, avoid conflicts of interest or even exercise 'independent judgment' when making decisions, but this requirement is commonly ignored or planned around.[93] Even if this requirement is breached, in the context of a solvent corporation, only minority shareholders (if any) are likely to complain, and they have a notoriously difficult time bringing directors to account.[94]

A tax system that incorporates no special rules for corporations and their relatives accepts, by doing nothing, the default manipulation available within the limited confines of corporate law. In such a system, the usual tax rules attach to transactions between corporations and their

[91] Group corporations tend to act in a similar manipulative fashion with respect to other potential liabilities, for example, corporate group structures are often manipulated in order to reduce exposure to involuntary creditors.

[92] A common example involves one group corporation paying expenses that might be considered to properly belong to another group corporation. *Centrica Overseas Holdings Ltd* v. *HM Revenue & Customs* [2021] UKUT 0200 (TCC) is an example of this where a parent corporation incurred professional fees when assets were sold by a subsidiary and sub-subsidiary. The issue was whether the parent could claim a deduction for the fees.

[93] For example, see Companies Law (China) Arts 147 and 148, AktG (Germany) s. 93, Companies Act 2006 (UK) ss. 172 to 177, MBCA s. 8.30. The DGCL does not codify directors' duties. Generally, see Cahn & Donald (2018, 393–99).

[94] For example, see Cahn & Donald (2018, chap 22).

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relatives. The system accepts that dealings between corporations and their relatives may be manipulated so as to reduce the overall tax liability that might otherwise be suffered. The potential for manipulation is particularly high with respect to controlled corporations, including group corporations. As the level of control decreases, so does the scope for manipulation. The tax arbitrage that a non-intervention approach permits is often referred to as 'self-help relief'. Obtaining this relief depends on well informed tax advisers assisting their clients in structuring transactions so as to achieve the averaging result for tax purposes.

Historically, this non-intervention approach was adopted for income tax purposes. However, as the twentieth century progressed, countries increasingly intervened in overriding for tax purposes the consequences of dealings between relatives, particularly between related and group corporations. In a domestic context, Canada is often viewed as one of the few developed countries still taking a largely non-intervention approach in the corporate income tax field.[95] In an increasingly integrated world, non-intervention is a dangerous approach, at least with respect to international transactions. Multinational groups endeavour to and do shift their profits to the lowest tax jurisdictions.[96]

The focus of this discussion (of the non-intervention approach) has been on the propensity of particularly group corporations to behave in a unified manner despite their separate legal personalities. However, the tax system can be faced with the opposite problem as well; where a person or corporation seeks to use or add artificial entities in order to secure some tax benefit multiple times. The most common example is where some particular tax benefit, for example a lower rate or credit, is attributed to each person. This creates an incentive to incorporate additional artificial entities so that persons can fragment their activities and secure the benefit multiple times. The easy use or addition of artificial entities is not something so easily replicated by, for example, adding members to a family of individuals.

1.1.4.2 Erosion of Identity

Rather than do nothing, a corporate tax system may directly intervene and prescribe rules that intentionally erode the separate identity of a corporation. These rules may be either beneficial, because they permit averaging

[95] See Canada (2010). Regarding the use of tax losses within Canadian corporate groups, see Suarez (2012).

[96] This was the impetus for the OECD's base erosion and profit shifting project, as to which see Harris (2020, 134–38).

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of tax consequences, or detrimental, because they allocate only one tax benefit between the corporation and its owners and controllers, for example a threshold for a lower tax rate or credit. Such rules most commonly apply to controlled corporations, but similar rules may apply to less integrated corporations and their owners and controllers. The following discussion focuses on controlled corporations.

The extent to which a corporate tax system erodes the separate identity of controlled corporations is another example of a spectrum issue. At one extreme, the separate identity of a corporation is collapsed, that is, consolidation of the corporation with its owners and controllers. At the other extreme of the spectrum the separate identity of a corporation is respected, but isolated tax attributes are singled out for transfer between the corporation and its owners and controllers (and other commonly controlled corporations).[97] Between these extremes, there is an array of hybrid approaches. The following discussion considers each of these in turn. The discussion does not evaluate the advantages or disadvantages of each approach. These are considered in particular contexts throughout the remainder of this book.

Each of these approaches involves the allocation of tax attributes to the owners and controllers of a corporation. The difference in approach is simply one of degree. An issue for all of these approaches is identifying who may be allocated tax attributes. In particular, an issue is whether minority owners without any degree of control may be allocated tax attributes of the corporation. This is the final matter discussed in this section.

Collapse of Separate Identity: Consolidation A corporate tax system may decide to simply ignore the identity of a corporation and identify its activities, assets and liabilities with its owners or controllers. In the current context, it is presumed that the corporation is of a form eligible to fall within the scope of the corporate tax system, but by reason of its relationship with its owners and controllers or an election of them, the corporation in question falls outside that system. This is consolidation, which collapses the identity of a corporation into that of its owners and controllers. It is most common in the context of corporate groups,[98] but

[97] Tax attributes are those features of a tax system that attach to tax subjects and which are carried forward from one tax period to another. The prime example is the tax value of particular assets. Other major examples include the carry forward of losses, credits and even a particular status, for example as a resident or exempt institution.

[98] In the context of corporate groups, it is often called the 'enterprise doctrine'; see Ting (2012, chapter 2).

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can also be adopted where the owners and controllers are non-corporates. In the latter case, as the corporation is taken out of the corporate tax system and its owners and controllers are not corporations, the corporate tax system is not engaged at all.

In its purest form, consolidation allocates all the activities, assets and liabilities of the corporation to the owners and controllers for tax purposes. If the allocation is to a single owner and controller, for example a parent corporation, the corporation (subsidiary) may be treated as a branch of the controller and this has important consequences. Transactions between the corporation and its controller (or between commonly controlled corporations) will be ignored. This result is on the basis that the corporation (or corporations) are merely part of the controller, and a person (the controller) cannot transact with itself.

This has further repercussions with respect to rights held by the controller against the corporation (or between two controlled corporations). These are also ignored. So, for example, in the context of pure corporate group consolidation, a loan between two group members is not a loan for the purposes of the corporate tax system. The shares and other rights held by the parent corporation in a subsidiary or by one group member in another group member *disappear* in pure consolidation.

Consolidation was the earliest form of corporate group treatment adopted by the UK. In 1915, the excess profits duty prescribed:

> Where any company … owns the whole of the ordinary capital of any other company carrying on the same trade or business … the provisions … as to excess profits duty … apply as if that other company were a branch of the first-named company, and the profits of the two companies shall not be separately assessed.[99]

This is a standard approach to pure consolidation and the Australian corporate tax system currently adopts a similar approach.[100] In the UK, the wholly owned requirement was reduced to 90 per cent in the 1937 National Defence Contribution and settled at 75 per cent in 1938. The consolidation approach was repealed with profits tax in 1965.[101] In Australia the holding requirement is 100 per cent.

Consolidation is most common in the context of corporate groups. However, it can be adopted with respect to other types of owners and

[99] Finance (No 2) Act 1915 (UK) Fourth Schedule para. 6.

[100] See Income Tax Assessment Act 1997 (Australia) s. 701-1. For an assessment of the Australian consolidation regime, see Cooper (2011).

[101] Generally regarding this history, see Harris (2011).

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controllers of a corporation, for example, an individual. A good example is the US check-the-box regime. As mentioned above, under this regime many non-corporate business entities, including LLCs, may elect whether to be treated as a corporation or transparent for tax purposes. In a case where the entity has a 'single owner' the choice is between 'an association [corporation] or to be disregarded as an entity separate from its owner'. Disregarded entity status is pure consolidation because the identity of the entity disappears for tax purposes, whether the controller is a corporation or an individual. If there are two or more owners, the choice is between an association or a partnership. Partnership status involves attributing to shareholders income that is accepted to be income of the corporation (discussed below at 1.3.3.2), which is a form of allocating tax attributes.[102]

Within a Separate Entity Approach: Transfer of Tax Attributes Rather than adopt a single entity approach, a corporate tax system might accept the separate identity of a corporation but erode the normal consequences of this for particular purposes by reason of the way the corporation is owned or controlled. For example, the system may facilitate the averaging of tax consequences by permitting the transfer of losses or other tax attributes between the corporation and its controller (and other controlled corporations of the controller). Similarly, the corporate tax system might apportion the benefits of particular rate thresholds and credits between a controller and controlled corporations in order to prevent problems of fragmentation. Most commonly, these types of rules only apply in the context of corporate groups.

Without specific rules, tax consequences attach to transactions between a controller and a controlled corporation, including group corporations. Further, rights between controller and controlled corporations and between commonly controlled corporations are recognised, such as loans and shares held by one group member in another group member. Specific rules that ameliorate the effects of such transactions are common. This is especially the case as between group corporations but can also occur in the case of individual controllers, particularly in the context of the corporation issuing shares.

Erosion of the separate identity of controlled corporations is the primary approach adopted by the UK corporate tax system, particularly with respect to corporate groups. The specific rules that the UK adopts

[102] Title 26 Code of Federal Regulations (US) § 301.7701-3(a).

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will be discussed at appropriate points throughout this book. This approach was first adopted with respect to the transfer of losses between members of a corporate group for income tax purposes in 1953.[103] This approach was carried through into the corporation tax in 1965 with substantial modifications in 1967.[104] Since 2014 China also provides an example of transfer of tax attributes with respect to transfers of assets between members of a wholly owned group of corporations. This is discussed further below at 1.2.3.1.

Hybrid Approaches Some countries appear to adopt what might be described as a hybrid of these two extreme approaches. They collapse the separate identity of controlled corporations for some purposes but respect their separate identity for others. Again, this is most prevalent in the context of group corporations. So, the US permits group corporations to file a consolidated tax return,[105] but this is not pure consolidation. Losses and certain other tax attributes are recognised at the group level. However, transactions between group members are recognised, but deferred. Shareholdings of one group member in another group member continue to be recognised, with adjustments.

The German approach is similarly a hybrid but very different in form. Under the *Organschaft* regime the tax results of group members may be transferred to the business of a controller. A controller is broader than just parent corporations and may include individuals and partnerships.[106] However, transactions between group members continue to be recognised.

Problems with Minority Owners As mentioned, each of these approaches involves the allocation of tax attributes to the owners and controllers of a corporation. The difference in approach is simply one of degree. An issue for all of these approaches is identifying who may be allocated tax attributes. This may be to all owners of the corporation, irrespective of whether a particular owner also has any degree of control of the corporation. Alternatively, only owners that are also controllers may be subject to attribution. Neither approach is entirely satisfactory in its treatment of corporations with minority owners, that is, owners that have no degree of control of the corporation.

[103] Finance Act 1953 (UK) s. 20.
[104] Generally regarding this history, see Harris (2011).
[105] IRC (US) s. 1501.
[106] KStG (Germany) s. 14.

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Attribution to All Owners Consider a pure consolidation system that collapses the identity of a corporation and allocates its activities, assets and liabilities to all of its owners, for example, shareholders. The attribution of activities, assets and liabilities of the corporation is proportionate to all owners and not just those that have some element of control. A consequence is that there are no membership interests, for example shares, recognised for tax purposes. The owners are considered to conduct the corporation's activities directly. Where the corporation has multiple owners, the result is fragmentation of the corporation's tax attributes and this has consequences when owners transact with the corporation.

For example, presume a corporation sells an asset to a 35 per cent shareholder. If before the sale the asset was considered owned proportionately by all shareholders, the sale to the 35 per cent shareholder will be recognised as a sale of a 65 per cent interest in the asset by the other shareholders to the 35 per cent shareholder. The other shareholders will recognise a gain or loss on their proportionate interest accordingly. This can become very complex as ownership of the corporation fragments, and means that this approach is only feasible in the context of closely held corporations. This approach also raises questions of fairness. The sale proceeds will be received by the corporation, but a minority shareholder has virtually no influence over whether the corporation distributes those funds. Nevertheless, the minority shareholder may have to report any gain on their proportionate sale of the asset and pay tax.

These difficulties with minority owners are not confined to an approach that collapses the identity of the corporation. Similar difficulties can arise where that identity is respected but some tax attribute of the corporation is allocated to a minority owner that has negative tax consequences for the owner. These problems are discussed in more detail below at 1.3.3 in the context of allocating a corporation's taxable income to its owners irrespective of distribution.

Attribution to Controllers Only The alternative is to only allocate tax attributes of a corporation to a particular controller or to a group of persons with a sufficient degree of control. This approach does not produce satisfactory results either in the context of a corporation with minority shareholders. This is because the approach results in either what may be viewed as an inappropriate indirect transfer of tax attributes or an inappropriate denial of the transfer of tax attributes. There are also difficulties in determining what constitutes a sufficient degree of control.

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As a general rule, tax systems do not permit the transfer of tax attributes, for example, a person is not permitted to sell losses to another person. The point of eroding the identity of a controlled corporation is to break down this rule. Return to the example given above of a corporation selling an asset to an owner. If the owner holds all of the shares in the corporation, there is some reason for saying that any gain or loss on the sale of the asset should not be recognised. This is because there has been no change in underlying or economic ownership of the asset such as to justify recognition that the gain has been realised for tax purposes. This sort of approach involves *looking through* the corporation (i.e. lifting the corporate veil) to see who its owner is.

It is easy to see why non-recognition might be accepted where the corporation is wholly owned by the purchaser or where the transaction is between two corporations that are wholly owned by the same person, for example by a parent corporation. But what if the ownership or common ownership is not complete? What if the corporation is owned only as to 75 per cent by the purchaser; should the transaction be recognised? There is no correct answer to this sort of question because it involves the spectrum of corporate ownership. If non-recognition is granted (whether through consolidation or otherwise), the tax system has permitted one quarter of the owners of the corporation to sell their indirect interest in the asset to a stranger without tax consequences. If non-recognition is not granted, the tax system has recognised a gain where the substantial majority of indirect interests in the asset have not changed, that is, form is applied over substance.

A middle ground might be to apply a proportionate recognition. This would involve eroding the identity of a corporation only to the extent of its controlling owners. The separate identity of the corporation would continue, proportionately, to represent the interests of the minority shareholders, that is, those who are not allocated any tax attributes of the corporation. Under this approach, the sale of the asset to the 75 per cent owner would be treated as a sale of a 25 per cent interest in the asset and the corporation would realise a gain or loss to that extent. This approach is different from full allocation to all owners discussed above. The sale is treated as made by the corporation, not by the shareholders.

Not only is proportionate recognition administratively difficult, but it is also not an accurate reflection of what has happened. The result is contrary to the very nature of a corporation as a collective investment vehicle. To recognise only 25 per cent of the gain in the example in the last paragraph does not result in tax consequences attaching to just the

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25 per cent of owners that might be viewed as having disposed of their interest in the asset. Because the shareholders are collective, it treats all shareholders the same. The 25 per cent who no longer have an indirect interest in the asset and the 75 per cent owner who still does are each treated, indirectly, as though they sold 25 per cent of their interest in the asset. This book discusses a number of examples that produce this sort of problem.

The bottom line is that in the absence of allocation to all owners proportionately, there is no right answer to the question of the degree of ownership and control required to erode the identity of a corporation for tax purposes, but some observations may be made. In the case of full ownership, the case for erosion of the separate identity of the corporation seems clear, at least in a domestic context. That case progressively falls away as ownership is fragmented to the point that it falls away when control by any particular owner is lost, that is to say, typically when there is no 50 per cent owner. Between 100 per cent and 50 per cent it is impossible to draw any clear line. One hundred per cent might seem unduly restrictive, while closer to 50 per cent makes the issues discussed above with respect to minority owners acute.

As noted at 1.1.3.2, the corporate law of most countries recognises other levels of control between 50 per cent and 100 per cent. One is the level of share ownership required to engage in constitutional reform of a registered company. Germany and the UK generally use 75 per cent for this threshold, and that is a common approach. This is the level of share ownership required to pass a special resolution.[107] In China a two thirds majority is required to change the articles of association.[108] While there is not, perhaps, a conclusive argument for use of this level as the threshold of ownership required for erosion of a corporation's identity, it does have some salient features. Such a level of common ownership increases the controller's ability to integrate the activities of the controlled company into the activities of the controller, that is, increases the potential that the corporation and controller will act as a single economic unit. Corporate law often uses other important thresholds that might be relevant, such as the level of share ownership required by a majority shareholder to force a minority shareholder to sell in a takeover (in countries where that is

[107] AktG (Germany) s. 179 and Companies Act 2006 (UK) s. 21. There is no requirement under either MBCA (US) or DGCL (US). Regarding required majorities for shareholder meetings in Germany, the UK and the US, see Cahn & Donald (2018, 601–03).

[108] Companies Law (China) Art. 103.

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possible). In the UK, 90 per cent is used for this threshold in some cases and in Germany it is 95 per cent (plus a court order).[109]

Should the threshold of ownership required for the transfer of tax attributes of a corporation depend on the particular attribute in question? Again, there is no clear answer to this question, but it *is* clear that countries do adopt different approaches. As will be discussed, the threshold for the direct transfer of tax attributes by a corporation (see below at 1.2.3) is commonly higher than is required for the indirect transfer of tax attributes (see below at 5.2.2). Should consolidation require full ownership? Minority owners do raise acute issues for consolidation regimes, but there are many examples of consolidation regimes with ownership requirements of less than 100 per cent. The former UK profits tax regime is an example. However, given its holistic nature, it might be expected that a consolidation regime would be at the top end of the threshold adopted by a country for erosion of identity of group corporations.[110]

1.1.4.3 Reinforcement of Identity: Independent Entity Approach

A corporate tax system may adopt the opposite approach and directly intervene to reinforce the separate identity of corporations in which ownership and control coincide, that is, corporations that are related to their owners. The system will do this by pretending that corporations and their relatives are not integrated and require these related parties to transact or, at least, report for tax purposes as though they had transacted as independent entities. This is known as the arm's length standard or independent entity approach and is classically reflected in the independent pricing of transactions between related entities.

The main problem with the independent entity approach is that it is anti-factual; it is asking related entities to behave in a manner that is not of their nature. This can be particularly problematic when the level of relationship is intense, such as in the context of controlled corporations and, in particular, group corporations. Inevitably, the result is a *cat and mouse game* between the legislature and the related entities, whereby legislatures continually prescribe rules to impose the arm's length standard and

[109] Companies Act 2006 (UK) s. 979 and Securities Acquisition and Takeover Law (*Wertpapiererwerbs- und Übernahmegesetz*) (Germany) s. 39a(1). There is no requirement under either MBCA (US) or DGCL (US). In China there is no right to force minority shareholders to sell in a takeover. Regarding the treatment of minorities in a takeover in Germany, the UK and the US, see Cahn & Donald (2018, 895, 900–901 and 907).

[110] Regarding ownership requirements in consolidation regimes, see Ting (2012, heading 5.4).

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related entities continually attempt to push the boundaries towards their integrated nature. As a result, tax legislation can get messy.

The independent entity approach is noted at a number of points throughout this book. It is particularly prevalent in the international field, where the stakes are high. In the international field, this approach is taken to such an extreme as to treat foreign permanent establishments ('PEs') of particular entities as though the PE were itself a separate entity.[111] This can create a dislocation between domestic rules and international rules, but such a dislocation can also occur in a purely domestic scenario. For example, there is some inconsistency in requiring group corporations to account on an arm's length basis for transactions between group members and yet permit such corporations to freely transfer losses to each other, see below at 1.2.2 and 1.2.3. The difference is commonly that the independent entity approach is adopted with respect to related parties, while the separate identity of group corporations is independently eroded by different rules.

Series or cell LLCs, which have become common in the US, provide an interesting analogy to the treatment of PEs under international tax rules. The laws that establish these companies permit assets and liabilities to be grouped into separate series or cells, which may be attributed to specific members or insulated from a liability perspective. Legally, it is like establishing a group of corporations within a single corporation. One question is whether each series or cell is to be treated as a separate entity for tax purposes. At the least, this seems possible in the US,[112] and so potentially creates the opposite result to pure consolidation. That is, parts of the same legal entity are treated as separate entities for tax purposes whereas consolidation treats separate legal entities as part of the same entity for tax purposes.[113]

1.1.5 Classifying Corporations by Their Owners and Controllers

Section 1.1.3 explored the relations between corporations and their owners and controllers. It remains to consider how corporations are categorised by reference to their owners and controllers for tax purposes. The discussion follows the varying degrees of ownership and control

[111] Regarding these rules, see Harris (2020, 194–209).

[112] US Federal Register, Vol. 75, No. 177, Tuesday, September 14, 2010 pp. 55699 and 55707 proposing Title 26 Code of Federal Regulations (US) § 301.7701-1(a)(5). The proposed amendments are yet to be finalised; see Jones (2016, 572).

[113] Generally, see Bishop (2011), Fuller (2010) and Jones (2016).

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identified at 1.1.3.2, that is, controlled corporations, close corporations and corporations more loosely related to a person with a remoter degree of ownership and control.

The focus is on general rules applicable in income tax law. As mentioned, rules applicable to the categories of corporations identified are considered in the remainder of this book. Further, in some specific circumstances the rules of identification are modified, or altogether different rules are used to identify corporations by reference to their owners and controllers. These specific identification rules are considered later in this book in the context in which the variations are relevant. Finally, the discussion does not consider the relations between foreign corporations and their owners and controllers. In particular, it does not consider controlled foreign corporations, which are briefly considered below at 3.2.2.1.

1.1.5.1 Controlled Corporations

Tax laws tend to identify three basic types of controlled corporation. The simplest type is a corporation controlled by a single individual. A second simple type is a corporation controlled by another corporation, that is, a parent corporation. In this case, the two corporations form a corporate group. The third basic type of controlled corporation is a commonly controlled corporation; see above at 1.1.3.3. Two corporations that are controlled by the same person or persons are said to be 'sibling' corporations and may also be considered to form a corporate group. The following discussion considers how tax laws categorise each type of controlled corporation.

A tax law may have specific rules that categorise each type of controlled corporation. However, many income tax laws incorporate a general concept of affiliated, associated, connected or related persons. This concept will include individuals and their relatives, typically within defined limits of consanguinity. It will also include relationships between individuals and artificial entities, usually based on control. It will also include relationships between artificial entities, again based on control or common control. So, controlled corporations are often identified by a tax law, at least in part, by reference to such a general concept.

The UK is an example of a country adopting this sort of approach. Its income tax laws incorporate a general concept of 'connected persons'.[114]

[114] CTA 2010 (UK) s. 1122. 'Connected persons' is defined in similar terms for income tax purposes (ITA 2007 (UK) s. 993), capital allowance purposes (CAA 2001 (UK) s. 575) and capital gains purposes (TCGA 1992 (UK) s. 286). The latter two definitions are considered in more detail below at 1.2.2. They are all clearly of the same origin.

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Although this concept is not used consistently for the purposes of the corporate tax system, it is the most generally used definition and is one way to categorise controlled corporations.[115] US income tax law less obviously uses a general concept. It does incorporate a concept of 'related taxpayers' or 'related persons',[116] which covers issues analogous to the issues covered by the UK concept of connected persons. In form, the US concept is for the purpose of identifying relationships to which a particular rule applies (disallowance of losses). However, the concept of related persons is picked up and applied by other provisions.[117] The definition of 'controlled group of corporations' is used in a similar fashion.[118]

By comparison, Germany has a general concept of 'relative', but this only applies as between individuals.[119] Separately, Germany has a concept of 'controlled company', including control by an individual, but this is for the specific purpose of transfer of income.[120] China does not have a general concept of 'relative'. However, for transfer pricing purposes it does have a concept of 'related parties' covering relationships between individuals, between individuals and artificial entities, and between artificial entities.[121] This concept is discussed below at 1.2.2.

The following discussion is for general illustrative purposes and so focuses on the most general rules for identifying controlled corporations. Further detail and different definitions in different contexts are provided at relevant points throughout this book.

Control by Individual An income tax law may identify a corporation as controlled by a particular individual. In this case, there will be two primary issues that must be addressed by the law. The first is the test used for determining whether control exists. The second is which rights are attributed to the individual for the purpose of determining whether the test is met. In particular, an individual may be attributed rights held by certain relatives and related entities for this purpose. China has no general example of a rule focused on control of a corporation by an individual.

[115] CTA 2010 (UK) s. 1176(1) says this definition applies 'unless otherwise indicated (whether expressly or by implication)'. It is not clear why this type of ambiguity is accepted.
[116] IRC (US) s. 267.
[117] For example, it is applied by IRC (US) s. 144(a).
[118] IRC (US) s. 1563(a).
[119] AO (Germany) s. 15.
[120] KStG (Germany) s. 14.
[121] See EITR Art. 109 and SAT Announcement [2016] No. 42.

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Test of Control Germany and the US have comparatively simple tests for determining whether an individual controls a corporation for tax purposes. In the US, under section 267(b) of the IRC an individual is 'related' to a corporation if the individual owns 'directly or indirectly' more than '50 percent in value of the outstanding stock' of the corporation. The value of stock test is interesting because in the context of corporate groups it is supplemented with a voting power test.

By contrast, voting power is the sole test used in the German Corporate Income Tax Law to determine whether a corporation is 'controlled' by another person. The controller can be an individual, provided the individual is conducting a business. The test is holding a 'participation in the controlled company … such that the majority of the voting rights of the shares in the subsidiary are held' by the controller.[122] Germany has a general rule attributing assets to the legal owner unless that person can be excluded by another from the benefits of the asset for its useful life.[123]

The UK approach is again far from simple. As mentioned, UK income tax law incorporates a general concept of 'connected persons'. In particular, a person (including an individual) is connected with a 'corporation' if the person has 'control' of the corporation.[124] Confusingly, 'control' for the purposes of this definition is taken from sections 450 and 451 of CTA 2010, rather than the proximate section 1124.[125] A person is treated as having 'control' of a corporation if they have an ability to exercise or acquire 'direct or indirect control' over a corporation's affairs.[126] Of course, this doesn't really define 'control', which, it seems, will take its ordinary meaning.[127]

In *Steele* v. *EVC International NV*, the Court of Appeal decided that 'control of the affairs of the company in [section 450(2)] means control at the level of general meetings of the company…' as opposed to at the board

[122] KStG (Germany) s. 14(1)1.
[123] AO (Germany) s. 39.
[124] CTA 2010 (UK) s. 1122(3).
[125] CTA 2010 (UK) s. 1123(1). Similarly, there is a definition of 'control' proximate to (but not used in) that of 'connected persons' in ITA 2007 (UK) s. 995 and CAA 2001 (UK) s. 574. TCGA 1992 (UK) s. 288 simply defines 'control' by reference to CTA 2010 (UK) ss. 450 and 451.
[126] CTA 2010 (UK) s. 450(2).
[127] CTA 2010 (UK) s. 1124 provides a more general definition of 'control'. Whether this definition can apply for purposes of s. 450(2) depends on whether, expressly or by implication, s. 450(2) indicates otherwise; s. 1176(2). While not without doubt, the better view seems to be that 'control' in s. 450(2) is interpreted without regard to s. 1124; see *Steele* v. *EVC International NV* [1996] STC 785 (CA) at 794.

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or other administrative level.[128] This narrow focus simplifies the concept of 'control' substantially, but not completely. More than 50 per cent of voting rights in a general meeting clearly amounts to control. Whether anything less could amount to 'control', for example, 45 per cent when the rest of the votes are dispersed broadly, is debatable.[129] Section 450(3) of CTA 2010 goes on to treat a person holding certain rights as having control of a corporation. These extensions include holding more than 50 per cent of the share capital or voting rights in the corporation or having more than 50 per cent of the rights to distributions of income or surplus on winding up.[130]

Attribution of Rights In determining whether a particular individual controls a corporation, a tax law may attribute to the individual rights held by certain relatives and related entities of the individual. For example, suppose a tax law seeks to test whether a corporation ('A Co') is controlled by an individual ('B'). B holds 35 per cent of the voting rights in A Co and a relative of B ('C') holds another 20 per cent of such rights. The question is whether the tax law should consider A Co as controlled by B. If C is an individual related to B, the tax law will take one of two approaches; it will either allocate the rights held by C to B for the purposes of the test or not. This is an all or nothing approach.

The situation is different if C is a corporation that is related to B because B controls C (under a previous application of the test). Here, if the tax law seeks to attribute the voting rights in A Co held by C to B, it may take one of two primary approaches. Like in the case where C is a related individual, it may attribute all of the rights held by C to B (the 'absolute' approach). So, B would have 35 per cent of the direct rights in A Co, plus a further 20 per cent of the rights attributed from C, and so B would control A Co. Alternatively, the tax law may only attribute to B the proportion of the rights held by C based on the percentage of the rights that B holds in C. So, for example, if B holds 60 per cent of the voting rights in C, B would only be attributed that percentage of the voting rights that C holds in A Co, that is, 12 per cent (60 per cent of 20 per cent, the 'proportionate'

128 *Steele* v. *EVC International NV* [1996] STC 785 (CA) at 794 per Morritt LJ.

129 Other provisions deal with such a scenario, for example CTA 2009 (UK) ss. 473 (loan relationship) and 837 (intangible assets), TIOPA 2010 (UK) s. 160 (transfer pricing) and TIOPA 2010 (UK) Part 9 A, Chapter 18 (controlled foreign companies). So, the better view seems to be that more than 50 per cent is required in the context of the definition in section 450 of CTA 2010.

130 CTA 2010 (UK) s. 450(3).

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approach). In this case, B's total holding would be 47 per cent (35 per cent direct and 12 per cent indirect) and B would not control A Co.

US income tax law uses a mixed approach in attributing rights to a person for the purpose of determining whether the person is 'related' to a corporation. For the purposes of determining the 50 per cent of stock test in section 267 of IRC, an individual is attributed stock held by family members, that is, an absolute approach. By contrast, an individual is allocated a proportionate share of stock held 'indirectly' through artificial entities, that is, other corporations, partnerships, estates or trusts. There are extensions for stock held through partnerships.[131] These are examples of a proportionate approach.

The German rules do not attribute voting rights of relatives to an individual for the purposes of determining whether the individual controls a corporation. This is because the question is essentially whether a particular business controls a corporation. On this basis, it is possible for a partnership of individuals to control a corporation.[132] Further, for the purposes of determining whether a majority of voting rights is met, an individual may be attributed voting rights held by a corporation in which the individual holds a majority of voting rights. The law is not express, but it seems this is a proportionate approach.

When attributing rights for the purposes of the definition of 'connected persons', the UK adopts the absolute approach. A person is connected with a corporation if the person has control of the corporation. This is extended so that a person is also connected with a corporation if that person and persons that are connected with the person control the corporation.[133] An individual is connected with certain relatives.[134] This means that a corporation controlled by an individual and the individual's relatives is connected with each of the relatives. It also means that a corporation controlled by an individual and corporations controlled by the individual (or the individual and the individual's relatives) is connected with the individual and those corporations. There are further extensions for partners in a partnership.[135] All of these extensions involve the absolute approach.

That is pretty complex, but when this is overlaid with the concept of 'control' from sections 450 and 451 of CTA 2010, the situation becomes

[131] IRC (US) s. 267(c).
[132] KStG (Germany) Art. 14(1)2.
[133] For example, CTA 2010 (UK) s. 1122(3)(b).
[134] For example, CTA 2010 (UK) s. 1122(5).
[135] For example, CTA 2010 (UK) s. 1122(7).

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dizzying. In particular, in determining whether a person has 'control' of a corporation, certain rights held by 'associates' may be attributed to the person.[136] 'Associate' is defined in section 448, in not dissimilar terms to those used for 'connected persons' in section 1122 (with exclusions). Again, the approach is the absolute approach. Why the definition of 'connected persons' is indirectly incorporated into the definition of 'associate' in this way is unclear. No doubt the legislature intended to throw the net wide, but that is little excuse for the lack of clarity. The situation is made worse because of the uncertainty as to whether 'person', where used in the definition of 'connected persons', includes the plural or a body of persons or whether the context requires otherwise (see discussion above at 1.1.1).

Control by Corporation Just as an income tax law may identify a corporation as controlled by a particular individual; it may identify a corporation as controlled by another corporation. Again, two primary issues arise: the test for control and the attribution of rights held by others.

Some countries use multiple definitions to identify corporations controlled by other corporations. The UK is a good example. Two companies are connected if one company controls the other company under the rules discussed above. Similarly, such companies are 'associated'.[137] Of more relevance in this regard are the various definitions of 'subsidiary' in section 1154 of CTA 2010. This section defines '51%', '75%' and '90%' subsidiaries in terms of the ownership of 'ordinary share capital' by one 'body corporate' in another body corporate. The reference to 'body corporate' means that an unincorporated association cannot be a parent or a subsidiary of another company.

The US approach is more consistent. Section 1563(a) of IRC contains a definition of 'Parent-subsidiary controlled group'. A parent is a corporation that holds at least 80 per cent of the voting power or value of shares in another corporation. This test is used in other contexts, for example, for determining whether two corporations are 'related' under section 267. However, in this case the test is modified to a 50 per cent test.[138]

This can be contrasted with the German approach discussed above. That approach applies the same rules for identifying whether a corporation is controlled by another corporation or controlled by an individual and so that approach is not further considered in this discussion.

[136] CTA 2010 (UK) s. 451(4).
[137] CTA 2010 (UK) s. 449.
[138] IRC (US) s. 267(f).

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China has an example of a rule triggered by one corporation controlling another corporation. It applies to a resident enterprise 'having 100% direct control over' another enterprise.[139]

The relevant degrees of ownership selected for the various types of subsidiaries may have some relevance in corporate law. Broadly, these were discussed above at 1.1.4.2 in the context of the problem of minority owners where the tax identity of a corporation is eroded. The 50 per cent holding tests in these corporate tax systems are sufficient to ensure passage of an ordinary resolution at a general meeting of shareholders. As noted above at 1.1.3.2, without more, this is typically sufficient to elect at least a majority of the board of directors of a corporation and, perhaps, the whole board. A 75 per cent holding (66.6 per cent in China) may be sufficient to pass a special resolution by which the corporation's constitution can be altered. Higher holding thresholds, such as the UK 90 per cent, are sometimes sufficient to engage in more extreme action, such as minority buyout (see above at 1.1.4.2).

Test of Control The test of 'control' used by the UK to determine whether two corporations are 'connected' or 'associated' was discussed above.[140] It is essentially a question of voting power at a general meeting. By contrast, the various definitions of 'subsidiary' in section 1154 of CTA 2010 (UK) refer to ownership of 'ordinary share capital'.[141] 'Ordinary share capital' is defined in terms of 'issued share capital' (by whatever name called) other than capital the holders of which have a right to a dividend at a fixed rate, but have no other right to share in the profits of the company.[142] This definition has certain anti-intuitive consequences. Shares may be ordinary shares even if they have no voting rights. Further, preference shares with a right to share in distributions on a winding up are considered ordinary shares.[143]

[139] Circular of MOF & SAT [2014] No. 109 Art. 3.

[140] CTA 2010 (UK) s. 450.

[141] This requirement means that, even if a company is a body corporate, it cannot be a subsidiary of another company if it does not have a share capital, for example, a company limited by guarantee or formed by charter, but apparently such a corporation could be a parent of a subsidiary. As noted above at 1.1.1.1, a limited liability partnership is a body corporate, but they are specifically excluded from any reference to 'company' for corporation tax purposes; CTA 2009 (UK) s. 1273(2). Such partnerships are not, however, specifically excluded from any reference to a 'body corporate'. So, a question is whether a limited liability partnership could be a parent of a corporation for purposes of working out whether it is a subsidiary.

[142] CTA 2010 (UK) s. 1119.

[143] The ordinary share capital requirement can cause particular uncertainty in the application of the 'subsidiary' definition to entities organised under foreign law, for example, a US LLC.

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There are further peculiarities when it comes to calculating the amount of ordinary share capital held by a body corporate in another body corporate. It is nominal share capital that is counted and not, for example, paid-up capital. Further, in order to count, the ownership of share capital must be 'beneficial ownership'.[144] Where shares are subject to a contract, it can be difficult to determine when beneficial ownership is lost. If another person has a right to specifically enforce a transfer of the shares, it is the other person that has beneficial ownership and not the legal owner.[145] Beneficial ownership will not normally pass under a contract subject to a condition precedent. However, it seems that beneficial ownership (as opposed to equitable ownership) will pass if the legal owner is 'bereft' of any substantial rights and left with a 'mere legal shell'.[146] In one case, an option to acquire shares did not pass beneficial ownership, even though the option was likely to be exercised.[147]

The US test requires a parent corporation hold 'stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote or at least 80 percent of the total value of shares of all classes of stock' in the subsidiary.[148] For this purpose, 'stock' excludes non-voting preference shares, treasury shares and certain other holdings.[149] The US commonly treats the holder of an option to acquire shares as the owner of the shares.[150] It otherwise deals with issue of shares subject to a contract through the attribution rules discussed below.

The Chinese rule noted above does not contain further details on what constitutes '100% direct control'.

Attribution of Rights An individual may be attributed rights of others for the purposes of determining whether the individual controls a corporation (see above). Similarly, a corporation may be attributed rights for the

The categorisation of foreign entities as a 'body corporate' was discussed above at 1.1.1.1. It seems likely that the same approach should be adopted in determining whether a foreign entity has a 'share capital', that is, focus on the foreign commercial law and analogise with UK corporate law. The position of HMRC is discussed in HMRC, *Company Taxation Manual*, at [CTM00515], available at https://bit.ly/3FaxQMI, accessed 15 June 2023.

144 CTA 2010 (UK) s. 1154(6).

145 *J. Sainsbury plc* v. *O'Connor* [1991] STC 318 (CA) at 331.

146 *Wood Preservation Ltd* v. *Prior (Inspector of Taxes)* [1969] 1 WLR 1077 (CA) at 1095 (per Lord Donovan) and 1097 (per Harman LJ), respectively.

147 *J. Sainsbury plc* v. *O'Connor* [1991] STC 318 (CA).

148 IRC (US) s. 1563(a)(1)(B).

149 IRC (US) s. 1563(c).

150 IRC (US) s. 1563(e)(1).

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purpose of determining whether the corporation controls another corporation. Again, a tax law incorporating attribution may adopt an absolute or proportionate approach.

The UK absolute rules discussed above in the context of individuals controlling corporations are also used in the context of determining whether a corporation is controlled by another corporation (and so the corporations are 'connected persons'). However, the UK uses a proportionate attribution approach in determining whether a corporation is a 'subsidiary' of another corporation. Here, the ownership of ordinary share capital can be calculated directly or indirectly. An indirect holding is a holding held through another body corporate. So, for example, if A Co holds 80 per cent of the shares in B Co, which holds 60 per cent of the shares in C Co, A Co has a 48 per cent indirect holding in C Co (i.e. 80 per cent of 60 per cent). Any direct holding of shares by A Co in C Co would be added to this amount.[151]

The US approach is very different. It attributes very few rights held by others to a corporation for the purposes of determining whether that corporation is a parent of another corporation. It requires the parent corporation to meet the holding requirement directly, other than in the case of rights subject to an option or held through a partnership or trust.[152] In applying these attribution rules, there is generally only one attribution, so only one corporation is treated as owning particular shares, but that attribution is done in a way that creates a controlled group. Further, the option attribution rule takes precedence.[153]

Again, the Chinese rule for wholly owned groups has no express provisions attributing rights.

Sibling Corporations As noted above at 1.1.3.3, two or more corporations may be under the common control of the same person. These are often referred to as 'sibling' corporations. Sibling corporations are affiliated, associated, related or, in UK terminology, 'connected persons'. Where the controller is another corporation (parent), they are all 'group corporations', including the parent. Corporations with a common non-corporate controller may also be referred to as 'group corporations', but this is less common and, in any case, the controller will not be considered part of the corporate group. Two or more corporations

[151] CTA 2010 (UK) ss. 1155–1157.
[152] IRC (US) s. 1563(d)(1).
[153] IRC (US) s. 1563(f)(2) and (3).

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may also be under the control of the same group of persons. Whether or not the persons making up the group are related or connected, the controlled corporations may be considered as connected, that is, they may also be sibling corporations. The following discussion first considers categorisation of sibling corporations controlled by a single person and then sibling corporations controlled by the same group of persons.

Control by Single Person Under UK income tax law, two corporations are 'connected' if they are both controlled by the same person, or each is controlled by a person and/or person's connected with that person.[154] By contrast, while the UK has generic definitions of various levels of 'subsidiary' (discussed above), it does not have a general definition of 'group' corporations. It has definitions of 'group' companies for particular purposes, and these tend to use (and adjust) the definition of 75 per cent subsidiary. As a result, two 75 per cent subsidiaries with a common parent are often considered part of the same 'group'.[155]

The US is more complicated in this regard and a distinction must be made between a 'parent-subsidiary controlled group' of corporations and a 'brother-sister controlled group' of corporations.[156] Corporations falling within either definition are necessarily 'related' persons.[157] Dealing with the latter first, two corporations are in a 'brother-sister controlled group' if they are held as to 50 per cent voting and value by the same individual. In determining whether the 50 per cent test is met, the US adopts a proportionate approach in allocating rights held through other artificial entities, including a corporation. This proportionate approach works in the same manner as the UK rules described above at footnote 151. One difference is that there is no attribution if the stock owned in another corporation is less than 5 per cent of the total value of stock in that corporation.[158]

For example, presume individual A holds 60 per cent of B Co, A holds 20 per cent of C Co and B Co holds 80 per cent of C Co. Using the proportionate rule, A indirectly holds 48 per cent of C Co (60 per cent of 80 per cent). So, A holds more than 50 per cent of both B Co (60 per cent direct)

[154] CTA 2010 (UK) s. 1122(2).

[155] For example, see CTA 2010 (UK) s. 152 and TCGA 1992 (UK) s. 170(3). Both of these provisions are considered further below at 1.2.3.

[156] IRC (US) s. 1563(a).

[157] IRC (US) s. 267(b)(3). Section 267(f)(1) modifies the tests in s. 1563 and so in some cases two corporations will be related despite not meeting the requirements of s. 1563.

[158] IRC (US) s. 1563(e)(4).

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and C Co (20 per cent direct and 48 per cent indirect). So, under the US rules B Co and C Co are a 'brother-sister controlled group'. If A held less than 5 per cent of the shares in B Co, A would be attributed none of B Co's holding in C Co.

By contrast, two subsidiaries are part of the same 'parent-subsidiary controlled group' if they are held as to 80 per cent voting and value by other members of the group.[159] This test inherently involves an absolute approach to attribution of rights. Once a subsidiary is held as to 80 per cent by a parent corporation, its complete holding in another corporation will count for purposes of determining whether that other corporation is in the group. For example, presume that A Co holds 80 per cent of the shares in B Co, A Co holds 20 per cent of the shares in C Co and B Co holds 60 per cent of the shares in C Co. The holding of B Co in C Co counts in full for determining whether C Co is within the group. So, in the example, each of A, B and C form a 'parent-subsidiary controlled group'.

The Chinese rule noted above regarding control of one corporation by another corporation also applies to multiple 'enterprises under 100 per cent direct control by the same resident enterprise'.[160] In this way, sibling wholly owned enterprises are part of the same corporate group as the parent corporation.

The German Income Tax Law contains no general rules for categorising corporations as sibling corporations.

Control by Group of Unrelated Persons Rather than being controlled by a single person, two or more corporations (the 'tested' corporations) may be under the control of the same group of persons. As mentioned, such corporations may be considered sibling corporations. For income tax laws that adopt this approach, the primary difficulty is how the relevant 'group' is identified. This discussion does not consider a group of related persons. That has effectively been discussed in the context of attributing to a person rights held by related persons for purposes of determining whether the person has control of a corporation. So, in this context, the group of persons is presumed to be made up of unrelated persons.

At its extreme, the group could be every person in the world, which would produce the ridiculous result that every corporation in the world is related. So, the group needs to be limited in some shape or form. The

[159] IRC (US) s. 1563(a)(1)(A).
[160] Circular of MOF & SAT [2014] No. 109 Art. 3.

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requirement could be simply that the group is made up of persons (and potentially their relatives) that hold shares in both tested corporations. This is still particularly broad and may be further limited in various manners. One approach would be to limit the common control of the tested corporations to rights held by a limited number of shareholders. Here there is an analogy with closely held corporations, discussed below at 1.1.5.2. Other limitations may be used, such as that the persons in the group act in some coordinated fashion, have a particular level of shareholding or hold shares in the tested corporations in the same proportion.

The US income tax law faces this issue in its definition of 'brother-sister controlled group' of corporations and in doing so identifies the group of persons by reference to number. Two corporations form such a group if

> 5 or fewer persons who are individuals, estates, or trusts own … stock possessing more than 50 percent of the total … voting power … or more than 50 percent of the total value of shares … of each corporation, taking into account the stock ownership of each such person only to the extent such stock ownership is identical with respect to each such corporation.[161]

While not without issue, it seems that the lower of the two percentages that a particular person holds in each corporation is what counts towards the 50 per cent threshold. In this context, each of the five individuals etc. may be allocated rights held by relatives, including rights held indirectly through artificial entities under the rules on constructive ownership discussed above.[162]

By contrast, the UK provides a good example of the difficulties that can arise when seeking to identify corporations as commonly controlled by a group of persons if the tax law does not prescribe some relationship for identifying the group. Section 1122(2)(d) of CTA 2010 provides that two companies are connected if:

> a group of two or more persons has control of both companies and the groups either consist of the same persons or could be regarded if (in one or more cases) a member of either group were replaced by a person with whom the member is connected.

This provision is deficient in that it fails to identify any limit as to what may constitute a 'group' of persons. A similar issue arises in the context of section 450(5). If 'two or more persons together' hold certain rights 'they

[161] IRC (US) s. 1563(a)(2).
[162] IRC (US) s. 1563(e).

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are treated as having control' of the company in question. What the difference might be between 'a group of two or more persons' (section 1122) and 'two or more persons together' (section 450) is difficult to fathom. The drafting is sloppy and inconsistent. These difficulties are further examined in the context of transfer pricing (below at 1.2.2).

Two further points can be made with respect to section 1122(2)(d) of CTA 2010. The reference to a 'group of two or more persons' might suggest that the reference to 'person' in the remainder of the section does not include the plural. If it did include the plural, the reference to 'group of two or more persons' seems superfluous.[163] Similarly, perhaps this context requires that a 'person' does not include a 'body of persons'. Second, this provision only connects the two controlled companies and does not, of itself, connect either company with any person in the group or connect persons in the group. This can be contrasted with the provision that treats a partner in a partnership as connected with other partners and their spouses and relatives.[164]

Outside of these examples, which are largely used for anti-abuse purposes, most countries do not include sibling corporations commonly owned by a group of persons within the concept of a corporate group. Usually, tax laws require a corporate group to be commonly controlled by a single parent corporation. This is the situation in the UK and the US. As mentioned above, Germany is an exception, where a corporate group may be headed by an individual or partnership (or even a PE in Germany of a non-resident) as well as a parent corporation.[165]

China is also an exception. The rule on wholly owned group corporations envisages two corporations being 'under 100% direct control by the same … enterprises'.[166] This is explained in terms of the two corporations having the 'same multiple parent companies'.[167] What is not clear is whether the 'multiple parents' must be related in any way or whether to qualify as one of a number of multiple parents a particular parent must hold a minimum interest in the controlled corporation, for example, as a substantial shareholder. It seems these are not requirements. By contrast, in terms of identifying related parties for transfer pricing purposes (see below at 1.2.2), it is not clear that sibling corporations commonly owned

[163] For a similar observation in the context of CTA 2010 (UK) s. 450, see below at footnote 181.
[164] CTA 2010 (UK) s. 1122(7).
[165] KStG (Germany) s. 14.
[166] Circular of MOF & SAT [2014] No. 109 Art. 3.
[167] SAT Announcement [2015] No. 40 Art. 1(4).

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by a group of persons are related as the provisions seem to require common ownership by 'a third party' (after attribution of rights).[168]

1.1.5.2 Closely Held Corporations

As noted above at 1.1.3.2, shareholders in a closely held corporation are often capable of acting collectively so as to control the corporation in a way that shareholders in widely held corporations cannot. As a result, many countries have special rules applicable to closely held corporations and so this category of corporation will need to be identified. A country that makes a distinction between widely and closely held corporations must grapple with the basic issue of why make such a distinction. At an extreme level, there is no obvious reason why the taxation of Wal-Mart Stores Inc, Industrial and Commercial Bank of China Limited, Siemens AG or BP plc should be the same as that of a *Mum and Dad* corporation.

In particular, the shareholders in large, listed corporations have little or no direct control over distribution policy of the corporation. The situation is very different in the context of closely held corporations. The importance of this difference is a particular theme of this book. However, drawing an arbitrary line somewhere in the spectrum between the extremes of Wal-Mart Stores Inc or BP plc and a *Mum and Dad* corporation inevitably causes difficulties. Such lines are open to manipulation for corporations marginally on one side or the other of the boundary.

The following discussion considers tax law identification of closely held corporations. Naturally, categorisation of a corporation as a closely held corporation depends on the number of persons holding share interests in or participating in the corporation. For present purposes, such share interests are referred to as 'participations' and the holders of participations are referred to as 'participators'. However, rarely does a corporate tax system adopt such a simple approach. Most contain additional factors that determine more precisely the type of closely held corporation sought to be identified for the purpose in question. These additional factors may pertain to a number of things and, in particular, the form of threshold, type of participation, attribution of participations, type of participator, level of participation and type of corporation.

Each of these is considered in turn. The discussion is solely concerned with identifying closely held corporations. Rules applicable to closely held

[168] SAT Announcement [2016] No. 42 Art. 2(7). Two corporations might be related parties if they have substantially 'common interests'.

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corporations are considered at appropriate points in the remainder of this book. For illustration purposes, the discussion uses the UK's close company and consortium regimes and the US's S corporation and personal holding company regimes. Neither the Chinese nor the German income tax laws separately categorise closely held corporations.

Form of Threshold Each regime identifying closely held corporations will directly or indirectly select a number of participators as the basis for the regime. For example, the UK has distinguished closely held corporations for special income tax treatment since 1922 and since this time the basic number has been five participators. This is still the primary number used in the UK's close company regime. By contrast, the UK indirectly uses a maximum of 20 participators in its consortium regime. The US also uses five participators in its personal holding company regime but uses 100 participators in its S corporation regime.

A closely held corporation regime must also identify a threshold to which the number of participators pertains. The selected number of participators may pertain to all participators in a corporation or just enough to meet a certain threshold such as some form of control. The US S corporation regime provides an example of a threshold applying to the total number of participators. It defines an S corporation as simply a corporation 'which does not … have more than 100 shareholders'.[169]

Where the number of participants refers to sufficient to constitute some level of control, a corporation could have any number of shareholders but, if its control is concentrated in the hands of just a few, it might nevertheless be categorised as a closely held corporation. The UK close company regime provides an example of this approach. Section 439 of CTA 2010 defines 'close company' in terms of a company under the control of five or fewer 'participators'. It also applies to a company under the control of any number of participators who are directors, an example of a qualification by reference to type of participator. The section goes on to drop the control test and alternatively define 'close company' to include a company where five or fewer participators or participators who are directors would have a right to more than 50 per cent of the assets of the company in a winding up.

[169] IRC (US) s. 1361(b)(1)(A). The US legislation defines a 'small business corporation', which becomes an 'S corporation' by making an election to be subject to the S corporation regime in Subchapter S. The consequences of making an election are that the corporation is treated in a way that is similar to a partnership, see below at 1.3.3.2.

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The concept of control in section 450 of CTA 2010 was discussed above at 1.1.5.1 and refers to control at the level of the shareholder meeting. It is expressed in the singular; 'a person' is taken to have control. It is clear from the definition of 'close company' that the rights of participators are to be aggregated in determining whether there is control of the company in question. This is confirmed by section 450(5), which provides that '[i]f two or more persons together satisfy any of the' tests for control, they are treated as having control of the company. This seems quite obvious in the context of the definition of 'close company' but is of particular relevance in other contexts where the section 450 definition of 'control' is used. For example, see the discussion of 'connected persons', above at 1.1.5.1.

The US personal holding company regime provides a similar example. It defines a 'personal holding company' to mean, amongst other qualifications, a corporation if 'more than 50 percent in value of its outstanding stock is owned, directly or indirectly, by or for not more than 5 individuals'.[170] Note that the US regime does not directly reference 'control', but the level of shares owned by the individuals is sufficient to pass a resolution at a shareholders meeting.

The UK consortium company regime provides a further example. The definition of a company owned by a consortium appears in section 153 of CTA 2010. The initial requirement is that the company is not a 75 per cent subsidiary of any particular company, and hence a consortium company must be owned by two or more shareholders. The second requirement is that at least 75 per cent of the company's 'ordinary share capital' is owned by other companies each of which beneficially owns at least 5 per cent of that capital. The latter requirements will be returned to shortly. However, the result is that a consortium company must be owned by at least two, but not more than 20 qualifying shareholders. Further, it is sufficient that the 75 per cent threshold is reached by qualifying shareholders. The remaining 25 per cent could be held by any number of shareholders.

Type of Participation Other questions in the identification of closely held corporations pertain to the nature of the participation (shares), that is, which type of interests in a corporation must a person hold in order to be counted towards the number of participators. The UK treatment of close companies has always been punitive and so 'participator' is defined broadly in terms of 'a person having a share or interest in the capital or

[170] IRC (US) s. 542(a)(2).

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income of the company'.[171] So a participator need not be a shareholder or member in a company; it is sufficient that the person hold certain rights with respect to the company. This is made clear by specific inclusions in the definition. 'Participator' extends to a person who has share capital, voting or distribution rights or a right to acquire such rights. Future rights are accelerated for this purpose.[172] Certain loan creditors are also included.[173] Of course, being a participator is not sufficient of itself; the participators as identified must also 'control' the company in question, as discussed above, and this is essentially a question of control at the shareholder level.

Participations under the UK's close company regime can be contrasted with the requirement for holding 'ordinary share capital' under the consortium company regime. Unlike the close company regime, the consortium company regime is beneficial for taxpayers. 'Ordinary share capital' takes its meaning from section 1119 of CTA 2010 and was discussed above at 1.1.5.1. It is substantially narrower than participations under the close company regime. In particular, it only includes issued share capital and excludes certain preference shares.

There is a similar dichotomy between the US's personal holding company regime and its S corporation regime. The former is punitive and the latter usually beneficial. For the purposes of the personal holding company regime, 'outstanding stock' can be extended to include securities convertible into stock if this would cause a corporation to qualify.[174] By contrast, 'stock' for the purposes of the S corporation regime is narrowed. In order to qualify as an S corporation, a corporation can only have one 'class of stock'.[175] A class of stock essentially pertains to rights to dividends and a difference in voting rights is ignored.[176]

Attribution of Participations As with identifying controlled corporations, in identifying closely held corporations there is the issue of whether rights held by related persons should be aggregated to be treated as held by one person. Alternatively, rights held by an artificial entity (say, a corporation or partnership) might be disaggregated so as to be

[171] CTA 2010 (UK) s. 454(1).
[172] CTA 2010 (UK) s. 451(2).
[173] CTA 2010 (UK) s. 454(2).
[174] IRC (US) s. 544(b).
[175] IRC (US) s. 1361(b)(1)(D).
[176] IRC (US) s. 1361(c)(4).

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treated as held by the participators of the entity (i.e. the shareholders or partners). If rights are aggregated or disaggregated then an additional issue is whether the legal owner still counts as a person holding rights in addition to the person who has been attributed the rights, that is, whether there can be double counting. These issues have important implications on how the number of participants is calculated in determining if a corporation is closely held.

The US personal holding company regime only applies to corporations controlled by five or fewer 'individuals'. This means there is no potential overlap of attribution of stock directly to an artificial entity and simultaneously indirectly to participators in the artificial entity. Where a participation is held by an artificial entity, the only question is whether that participation will be attributed to any individual. Section 544 of IRC contains constructive ownership rules for purposes of the personal holding company regime. Any stock owned by an artificial entity (corporation, partnership or trust) is considered owned proportionately by members of the entity. So, in this sense there is disaggregation, but no issue of double counting. Further, an individual may be attributed stock owned by a family member or a partner of the individual. In this sense there is aggregation. The issue of double counting (both the legal owner and the constructive owner) could arise here, but is addressed by aggregating 'only if, the effect is to make the corporation a personal holding company'.[177] Stock subject to an option is considered owned by the option holder.

The US S corporation regime is similar in that it focuses on stock held by individuals. Generally, an S corporation may not have other types of shareholder. This means that the focus is on direct holdings and holdings held indirectly through artificial entities are irrelevant. This means the attribution rules are simpler. All members of a family are treated as one shareholder and so there cannot be double counting. The definition of 'family' is substantially broader than that in the personal holding company regime.[178] The one exception to the focus on direct holdings is where a corporation is wholly owned by another corporation that qualifies as an S corporation. In this case, the subsidiary is treated as transparent.[179]

The UK consortium company regime is, like the US's S corporation regime, generally favourable to taxpayers and so, like the S corporation regime, it focuses on direct holdings. This regime contains no rules for

177 IRC (US) s. 544(a)(4).
178 IRC (US) s. 1361(c).
179 IRC (US) s. 1361(b)(3).

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attributing shares held by one person to a related person. However, a corporation cannot be a consortium company if it is a 75 per cent subsidiary of a particular corporation. As the 75 per cent test is calculated by direct or indirect holdings (see above at 1.1.5.1), the attribution rules for the 75 per cent test are incorporated indirectly. The UK consortium company regime has one direct example of an attribution rule. A company is treated as held by a consortium if its main business consists of conducting a trade and it is a 90 per cent subsidiary of a holding company that is owned by a consortium.[180]

By comparison to these examples, the UK close company regime rules are deficient. As in the US, these rules attribute certain rights to a person for purposes of determining whether a company is controlled by five or fewer participators. These are the rules in section 451 of CTA 2010, which were discussed above at 1.1.5.1. In particular, a person is attributed rights held by another on the person's behalf. A person is also attributed rights held by associates and any companies controlled by the person or the person's associates. 'Associates' is defined in section 448 in the usual way to include certain family members. It also includes partners and certain trustees. The confused relationship between 'associates' and 'connected persons' was discussed above at 1.1.5.1.

The definitions of 'participator', 'control' and 'associate' in Chapter 2 of Part 10 of CTA 2010 provide good examples of the problems that can arise for an income tax law in dealing with artificial entities. Consider, for example, the use of the word 'person' in all of these definitions. In principle, the word 'person' takes its meaning from the Interpretation Act 1978, unless the context otherwise requires (see above at 1.1.1). Does 'person' in the close company rules include a 'body of persons'? If so, it seems possible that a partnership or the trustees of a trust might be a person for the purposes of these rules. But do the references to partners and trustees in section 448 suggest that a 'body of persons' is excluded? Without more information, perhaps bodies of persons are included, and this would give rise to issues of double counting.

Less clear is whether the singular 'person' is intended to include the plural 'persons'. Why might this matter? The problem is that the definition of 'close company' in section 439 of CTA 2010 puts a number on the participators that must have control (unless they are directors). If the singular includes the plural, this limit to five might be effectively lifted. Does

[180] CTA 2010 (UK) s. 153(3). The trading company does not meet this test if it is a 75 per cent subsidiary of another company (other than the holding company).

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the context require the plural of 'person' to be excluded in the definitions of 'participator' and 'control'? Section 450(5) seems to suggest such exclusion in the context of the definition of 'control'.[181] By extension, it seems bizarre that 'person' could include the plural in the definition of 'participator' but not in the definition of 'control'. Perhaps the context requires the plural to be excluded for the whole of Part 10 of CTA 2010 on close companies?

Does the apparent exclusion of the plural with reference to 'person' impact on whether the context requires that term to include 'bodies of persons'? A body of persons necessarily includes more than one person. If a body of persons is included, that might have an impact on how the limit to five persons is calculated. Further, if a body of persons is included, does this mean that the persons that make up the body are not counted individually? Illustrated simply, if a company is controlled by a partnership of ten unrelated individuals or controlled by a trust with ten unrelated trustees, is the company a close company or not?

Part of the answer may lie in section 451(6) of CTA 2010, which, like its US equivalent,[182] suggests that such rights are to be attributed to associates 'as will result in a company being treated as under the control of 5 or fewer participators if it can be so treated'. So, in principle, the rights of the partners could be attributed to one of them to cause the company to be a close company. But that is not a complete answer, because if the partnership were the person then it would obviously control the company. In the case of the trust, there is nothing that treats the trustees as associates. The trustees, as a body of persons, might cause the company to be a close company. But if a body of persons is not a person for the purposes of the close company rules, would a single trustee (where there are a number of them) have control of the company?

A fundamental problem with the UK rules is that they have the potential to simultaneously attribute the same participation to more than one person without clarification as to whether this is to be the case and, if so, how it is to work. This potential overlap is reflected in the need for some specific exclusions from the UK close company regime. A company is not a close company if it is controlled by non-close companies.[183] A major impact of this provision is to exclude subsidiaries of listed companies from

[181] Lord Neuberger was of the same opinion in *Kellogg Brown & Root Holdings (UK) Ltd* v. *RCC* [2010] EWCA Civ 118 (CA) at [31] but refused to decide the matter.

[182] IRC (US) s. 544(a)(4).

[183] CTA 2010 (UK) s. 444.

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being close companies. A company is not a close company if at least 35 per cent of the voting rights in the company are allotted to the public and quoted.[184] This exception is subject to anti-abuse rules. These exceptions would not be necessary if the UK rules, like the US personal holding company rules, only counted individuals towards the holding requirement.

Type of Participator The rules identifying a closely held corporation might require the participations in it to be held by a particular type of person. The lack of a limitation in the UK close company regime is one of the factors leading to the difficulties discussed under the last paragraph heading, 'Attribution of Participations'. One manner in which this regime does specify the type of participator is with respect to participators who are directors. Where participators who are directors control a company, the company is a close company even if it takes more than five of the directors to control the company, that is, the number limitation is lifted.[185]

As noted, both the US personal holding company regime and the S corporation regime effectively require participators to be individuals. There are limited extensions in both cases for stock held by certain trusts.[186] The S corporation regime incorporates a further limitation in that all participators must be resident.[187]

In the UK consortium company regime, the participators in the consortium company must be 'companies'. Like the definitions of 'subsidiary' discussed above at 1.1.5.1, there is a requirement that the 'company' be a body corporate.[188]

Level of Participation It may be that a particular participator must have a certain level of participation in a corporation to count towards the number of participators needed to identify the corporation as a closely held corporation. The UK consortium company regime provides an example of this approach. A particular company must hold at least 5 per cent of the ordinary share capital of a consortium company in order to qualify as a 'member' of the consortium.[189] None of the other regimes (UK close company regime, US personal hold company regime or US S corporation regime) incorporates a similar requirement.

[184] CTA 2010 (UK) s. 446.
[185] CTA 2010 (UK) s. 439.
[186] IRC (US) ss. 542(a)(2) & 1361(c)(2).
[187] IRC (US) ss. 1361(b)(1)(C).
[188] CTA 2010 (UK) s. 188.
[189] CTA 2010 (UK) s. 153(2).

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Type of Corporation Finally, a corporation might have to be of a particular type or conduct particular activities in order to be identified as a closely held corporation. So, for example, originally a company had to be a UK registered company in order to be a close company. The current definition applies to all types of 'company' (i.e. including unincorporated associations), but non-resident companies cannot be a close company.[190]

The US personal holding company and S corporation regimes exclude corporations conducting particular activities. In particular, certain financial institutions and insurance companies are excluded.[191] The personal holding company regime has further limitations. In particular, foreign corporations are excluded. Further, a corporation is not a personal holding company if less than '60 percent of its adjusted ordinary gross income … for the taxable year is personal holding company income'.[192] 'Personal holding company income' is defined broadly to catch any attempt to shelter either passive income or income from personal services in a corporation.[193]

1.1.5.3 Associated Corporations

As discussed above at 1.1.3.2, even in the context of widely held corporations, there are some owners that might be viewed as having some degree of control or influence of the corporation despite not holding a majority ownership interest. As noted, corporate law commonly recognises a concept of 'substantial shareholder', and it was suggested that a substantial shareholder might be considered as 'associated' with the corporation. Tax laws might also identify certain persons as associated with a corporation. These are persons with a substantial shareholding that are neither controllers of the corporation nor grouped with other persons that together control the corporation. In this way, a corporation might be associated with either an individual or another artificial entity.

The income tax laws under consideration do recognise corporate owners that might be viewed as 'substantial' at a number of points, but they do not incorporate a generally applicable definition. One UK example has already been discussed in the context of a 5 per cent corporate

[190] CTA 2010 (UK) s. 442. The extension to all 'companies' except non-resident companies was introduced in 1965. See Harris (2011).
[191] IRC (US) ss. 542(c) & 1361(b)(2).
[192] IRC (US) s. 542(a)(1).
[193] IRC (US) s. 543.

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holder of shares in a consortium company. Other common examples apply in the context of transfer pricing rules, for example, where China uses a 25 per cent ownership threshold. Another common threshold in this regard is a 10 per cent ownership interest in the context of dividend relief, but other thresholds that might be viewed as substantial are used in rules that are considered throughout this book. These rules include those considered below at 1.2.2 (transfer pricing), 1.3.3.3 (personal services corporations), 2.4.3.1 (exemption of intercorporate dividends), 3.2.2.3 (underlying foreign tax relief) and 5.1.3.1 (participation exemption) and 8.2.2.1 (dividend stripping).

1.2 Corporation Tax Base Issues

Once a tax law has identified corporations and determined that they are capable of making and receiving payments, that is, that they can be attributed income, the manner in which that income is calculated must be determined. For the vast majority of countries, the manner in which corporate income is calculated is the same as the manner in which the income of an individual is calculated, especially the business income of individuals. Even those countries that have a separate corporation tax law tend to define the corporation tax base by reference to rules used to calculate the personal income tax base. Germany and the US are examples of this approach.[194] Effectively, this was also the UK approach until the tax law rewrite, that is, the general rules for calculating the corporation tax base were the same as for calculating the income tax base of individuals.

However, a country may also calculate the corporation tax base entirely separately from the calculation of the tax base for personal income tax purposes. There are a number of reasons why this approach seems less than optimal, at least from a legal perspective.[195] The volume of the law duplicated can be substantial. Such an approach facilitates increasing divergence between the corporate and personal tax bases. It means that interpretations and rulings with respect to provisions used in the

[194] KStG (Germany) s. 8(1) generally applies the provisions of EStG for the determination of corporate income. IRC (US) Subchapter B (ss. 61 to 291) on the 'Computation of Taxable Income' generally applies to both corporations and individuals.

[195] There is a wide range of literature, particularly of an economic nature, about whether the corporate tax base should be based on income/profits at all. A widely touted alternate tax base is a cash flow tax base (of various varieties). For recent discussion, see Devereux et al. (2021, chapter 2) and Warren (2021).

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calculation of one tax base do not obviously apply to the calculation of the other tax base. There seems no overriding policy reason why the corporation tax base should not have at least a core set of tax base rules in common with those for the personal income tax base. Additionally, there is a real need for the corporation tax base to interface properly with the personal income tax base, especially in the context of closely held corporations. This issue can have serious distorting effects when a person decides on choice of vehicle for conducting an activity, an issue that is returned to in the context of incorporation (discussed below at 4.2).

The Chinese and UK income tax laws provide examples of calculating the corporation tax base entirely separately from the calculation of the personal income tax base. In China, from their implementation in 1980 the IITL and the EITL (including predecessors) have always been separate. This is a reasonably clear separation where there are no obvious rules applied by both laws. In the UK the separation only came about with the tax law rewrite project and, particularly, with the passage of ITTOIA 2005. This was reinforced when many of the rules rewritten in ITTOIA 2005 were rewritten a second time (in slightly different forms) in CTA 2009 and CTA 2010 and applied only to corporations. Nevertheless, unlike in China, the UK separation is fragmented and incomplete. Common rules in TCGA 1992, CAA 2001 and ITOPA 2010 apply to calculating the tax base of both individuals and corporations. At a number of points this book notes confusions caused by duplication of Chinese and UK rules.

Irrespective of whether there is duplication, general tax base issues such as the calculation of depreciation and timing of amounts are not income tax issues that are peculiar to corporations. According to the definition adopted by this book (see the introduction), they are not features of a corporate tax system and so are not considered in any detail. However, as noted at the start of this chapter, there are a number of special tax base issues that are peculiar to corporations. Some involve the interface between the corporation tax base and corporate law. This is the first matter discussed in this section, that is, whether and to what extent the corporation tax base follows corporate law rules for the calculation of profits.

The sub-categorisation of corporations by reference to their owners and controllers was discussed above at 1.1.3 to 1.1.5. As noted at 1.1.4, other than do nothing, a corporate tax system may either reinforce or erode the separate tax identity of controlled or related corporations. Reinforcing rules are discussed in section 1.2.2. These primarily involve the issue of an

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arm's length approach to transfer pricing. Eroding rules are discussed in sections 1.2.3 and 1.2.4. Section 1.2.3 specifically considers eroding rules for group corporations. These involve both the non-recognition of gain or loss on transactions between related corporations and the use of a loss incurred by one corporation against the profits of a related corporation. Section 1.2.4 considers eroding rules for corporations otherwise related with another person, that is, related in a non-group context.

Section 1.2.5 considers special corporation tax base rules for corporations arising from the interface with the personal income tax base. This interface may be caused by events occurring during the life of a corporation that raise issues as to the extent to which the corporation tax base and the personal tax base reflect each other. The interface also arises by reason of special tax base rules designed with individuals in mind and whether corporations should be excluded from these special rules and, if so, how those rules should be identified.

1.2.1 General Rules and Corporate Law

1.2.1.1 Schedular versus Global

The introduction explained the income tax in terms of a tax on realised creations of wealth and payments as the building blocks of the income tax base. There are limited activities by which wealth can be created, often referred to as 'income earning activities'. In the context of individuals, every income tax law has to identify income-producing activities in order to distinguish them from personal activities and, in particular, consumption. There are three main categories of income earning activity, which reflect resources available to produce new wealth.

An individual may use just their own labour to generate new wealth. The primary example of this is 'employment', although this term carries a technical legal meaning in all countries that is both broader and narrower than the simple provision of labour. A person may passively use just assets to generate new resources, commonly referred to as 'investment'. Thirdly, a person may use, in a myriad of proportions, a mixture of labour and assets to produce new wealth. The broadest term that is typically used to describe this combination is 'business' or 'enterprise', although it may, as in the case of the UK, encompass narrower concepts such as trade, independent contractor, profession, calling, vocation, occupation, etc.

A tax law that calculates income separately for each earning activity conducted by a person is referred to as a *schedular* system. The amount of income from each activity is then typically aggregated to produce a total to

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which tax rates apply, although increasingly different tax rates are applied to different activities. A schedular system is contrasted with a *global* system under which a person makes only one calculation of the person's aggregate income, that is, there are no separate calculations for particular earning activities.[196] The majority of countries adopt a schedular system, at least to some extent and especially with respect to the income of individuals. This is true of the UK.[197] Indeed, the UK's early income tax law dating from 1799 taxed different types of income according to different 'schedules' and this is the origin of the reference to a *schedular* tax system.[198] The German Personal Income Tax Law is also schedular,[199] as is the Chinese IITL.[200] By contrast, the US income tax law has historically been viewed as global.[201]

Just because an income tax law adopts a schedular approach with respect to individuals does not mean that it will do so with respect to corporations. In many countries, corporations (especially registered companies) are required to prepare financial accounts under commercial or corporate

[196] Generally, see Arnold, Ault & Cooper (2019, 271–72).

[197] For individuals, the schedular system is listed in ITA 2007 (UK) s. 3 and reflected in ITEPA 2003 (UK) (employment), ITTOIA 2005 (UK) Part 2 (trade, profession and vocation), Part 3 (land), Part 4 (debt claims, shares) and Part 5 (intangible property, other income) and TCGA 1992 (UK) (capital gains). Corporations are discussed below.

[198] Generally, see Harris (2006, 380–420 and 426–34).

[199] EStG (Germany) s. 1 charges income tax under various heads. Income from a particular activity is calculated as either profit or excess of receipts over costs; s. 2(2). The law proceeds to set out rules regarding each of these calculation methods (ss. 4 to 12) and then rules for calculating each type of income, for example, agriculture and forestry (ss. 13 to 14), business activity (ss. 15 to 17), self-employment (s. 18), employment (s. 19), holding capital assets (s. 20), renting and leasing (s. 21) and other income (ss. 22 to 23). The aggregate of income from these categories is taxable income to which tax rates are applied; s. 2(5).

[200] IITL Art. 2 specifies nine types of income. Article 3 applies different tax rates to income from different types of earning activities. Article 6 specifies the tax base differently for different types of income. The result is that the first four categories (employment, labour, author's remuneration and royalties) are calculated on a gross receipts basis (less a flat deduction), aggregated and taxed at progressive rates from 3–45 per cent. Income from business is calculated on a net basis (after business expenses) and taxed under a different progressive scale from 5–35 per cent. The remaining items of income (interest, dividends and bonuses; lease of property; transfer of property; and incidental) are taxed on a gross receipts basis (less some notional deductions for income from lease of property) at a flat rate of 20 per cent. The result is a highly fragmented system.

[201] IRC (US) s. 61(a) defines 'gross income' to mean 'all income from whatever source', that is, it is an aggregate concept. 'Taxable income', to which tax rates apply, is defined as gross income less allowable deductions; s. 63(a). Deductions are granted generally in calculating taxable income rather than in calculating income from any particular activity; for example, s. 161. However, the Trump tax reforms of late 2017 introduced a specific deduction for income from business (IRC s. 199A), which some view as a break with the comprehensive (global) nature of the US personal income tax. See Arnold, Ault & Cooper (2019, 249–53).

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law. For example, this is reflected in Article 164 of the Chinese Companies Law and Article 25 of the Chinese Accounting Law, Book 3 of the German Commercial Code (*Handelsgesetzbuch*, HGB) and in Chapter 4 of Part 15 of the UK Companies Act 2006. These accounts include a requirement to prepare a profit and loss account, which gives rise to questions as to the relationship between corporate financial accounts and the corporation tax base for income tax purposes (discussed below). In particular, the accounts must reflect the financial position of the 'company' and so are inherently *global* in nature.[202]

In many countries, including the UK and the US, there is no similar general requirement for individuals to prepare financial accounts. Indeed, in the US there is no general legal requirement for corporations to prepare accounts under corporate laws such as the MBCA or the DGCL. However, if a corporation's shares are publicly traded and regulated by the Securities Exchange Commission the corporation is required to file certain 'financial statements' under the Securities Act of 1933 and the Securities Exchange Act of 1934. These statements are detailed in regulations, which generally implement (at least implicitly) generally accepted accounting principles.[203]

This requirement to file global financial accounts is extended in the context of group corporations. A parent corporation is typically required to also prepare group financial accounts for corporate law purposes.[204] Corporate group financial accounts must be prepared for a parent corporation and, broadly, all the corporations it controls (subsidiaries).[205]

[202] For example, Accounting Law (China) Art. 25 requires companies to 'verify, compute and record their assets, liabilities, creditor's rights, income, expenses, costs and profits', and Commercial Code (HGB) (Germany) s. 264(2) refers to 'a true and fair view of the assets, liabilities, financial position and results of the company'. See also the Companies Act 2006 (UK) s. 396(2).

[203] Title 17 Code of Federal Regulations (US) Part 210. The relevance of generally accepted accounting principles is recognised by Securities Exchange Act of 1934 (US) s. 13(b)(2)(B)(ii) (US Code Title 15 Chapter 2B s. 78m(b)(2)(B)(ii)) and the power of the Securities Exchange Commission to recognise US GAAP is set out in s. 78s(b).

[204] For example, for EU corporations listed on EU stock exchanges, see *Application of International Accounting Standards*, Council Regulation (EC) No. 1606/2002. For China, see Accounting Standards for Business Enterprises No. 33 Circular of the Ministry of Finance (MOF) [2014] No. 10 issued by the Ministry of Finance 17 February 2014. For Germany, see Commercial Code (HGB) (Germany) s. 290, and for the UK, see Companies Act 2006 (UK) s. 399. For the US, see Securities Exchange Act of 1934 (US) s. 13(b) (US Code Title 15 Chapter 2B s. 78m(b)) and Title 17 Code of Federal Regulations (US) § 210.3-01 and 02.

[205] 'Subsidiary' is broadly defined in Companies Act 2006 (UK) s. 1162 according to a number of tests. These including a parent holding a majority of voting rights in the subsidiary, having the right to appoint a majority of the board of directors of the subsidiary or having

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Most commonly, these accounts are prepared on a pure consolidation basis (see above at 1.1.4.2), that is, as though the corporations 'included in the consolidation … were a single company'.[206] As with the financial accounts of single corporations, group financial accounts are prepared on a global basis.

Consistent with the global nature of corporations' financial accounts, the Chinese, German and US corporation tax bases adopt a global approach. The US simply applies the same global approach for corporation tax purposes as it applies to individuals.[207] While Germany applies a schedular approach to the taxation of individuals, this is modified to a global approach when applied to corporations. All income derived by resident corporations is 'treated as income from business operations.'[208] In China an enterprise's 'taxable income' is its total income less deductions.[209] 'Total income' is made up of various heads (including an 'other incomes' head).[210] However, expenses are generally deductible against total income in calculating 'taxable income', producing a global approach.[211]

As noted above at 1.1.4.2, the corporate tax systems of Germany and the US adopt hybrid forms of consolidation. These regimes are discussed further below at 1.2.3. While these systems adopt a global approach for

the power to exercise a dominant influence over the subsidiary. Similarly, see Commercial Code (HGB) (Germany) s. 290(2). By contrast, Title 17 Code of Federal Regulations (US) § 210.3-02 defines 'subsidiary' simply in terms of 'control', which is defined as 'the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting shares, by contract, or otherwise'. However, consolidation of accounts is only required for 'entities that are majority owned'; § 210.3a-02(a). Similarly, China defines 'parent' and 'subsidiary' in terms of 'control', but there is a presumption of control if the parent 'holds more than half of the voting rights' in the subsidiary; Accounting Standards for Business Enterprises No. 33 Circular of the MOF [2014] No. 10 Arts 2, 7 and 13.

206 Large- and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008 (SI 2008/410) (UK) Schedule 6 para. 1(1). For a similar requirement, see Commercial Code (HGB) (Germany) s. 297(3). By contrast, Title 17 Code of Federal Regulations (US) § 210.3a-04 requires the elimination of 'intercompany items and transactions between persons included in the … consolidated financial statements'. Again, China is similar in requiring 'offsetting' of 'internal transactions'; Accounting Standards for Business Enterprises No. 33 Circular of the MOF [2014] No. 10 Arts 26, 30, 34, 40 and 45.

207 The system is not entirely global. In particular, capital losses are quarantined from the global income calculation; IRC (US) s. 1211(a).

208 KStG (Germany) s. 8(2).

209 EITL (China) Art. 5.

210 EITL (China) Art. 6.

211 EITL (China) Art. 8.

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calculating the income of individual corporations, this is not the case when it comes to the consolidated results for corporate groups. Due to their hybrid nature, each of these regimes incorporates schedular aspects, that is, some corporation tax base attributes are retained by individual members of a group. So, in this regard, these systems do not follow the global approach in group financial accounts.

This can be contrasted with the approach in Australia, which adopts pure consolidation for corporate groups in its corporate tax system (see above at 1.1.4.2). While group consolidated income under Australia's regime does not follow that in group financial accounts, Australia does adopt an essentially global approach in calculating group consolidated income for tax purposes. However, the level of holding required for tax consolidation in Australia is 100 per cent, much higher than the quasi-50 per cent requirement for group financial accounts.

Financial accounts are prepared on a yearly basis and this does not necessarily coincide with the standard tax year under a tax law. So, it is common to permit taxpayers, especially those in business, to calculate their tax base for a year by reference to the period for which their accounts are made up. For example, in Germany, while the tax year is generally the calendar year, with the approval of the tax administration the business profits for a particular year are the profits of the business for any accounting period ending in that year.[212] In the US, the taxable year is also commonly the calendar year but taxpayers may select another fiscal year (12 months) to be their taxable year.[213] By contrast, China fixes the tax year as the calendar year.[214] However, just because a corporation tax base is global or is calculated according to the same period as a corporation's financial accounts does not mean that the corporation tax base follows the financial accounts or that there is even a close connection with a corporation's financial accounts. That is discussed further below.

As usual, the UK approach is comparatively a mess. The corporation tax base is schedular and is broadly similar to (but not the same as) that adopted for individuals. Corporation tax is charged on the 'profits' of a company for a financial year.[215] The financial year commences on 1 April and finishes on 31 March.[216] However, profits are determined according

[212] EStG (Germany) s. 4a.
[213] IRC (US) s. 7701(a)(23) and (24).
[214] EITL (China) Art. 53.
[215] CTA 2009 (UK) s. 2(1).
[216] CTA 2010 (UK) s. 1119 and Interpretation Act 1978 Schedule 1.

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to accounting periods and then apportioned to financial years, if these are not the same.[217] Accounting periods are determined by reference to the date that a company makes up its accounts.[218] This and the reference to 'profits', might suggest that the UK corporation tax base is global and that there is a close relationship with financial accounts. That, however, is not the case.

'Profits' is defined in terms of 'income and chargeable gains'.[219] Chargeable gains are calculated under TCGA 1992, and income is calculated under the various heads listed in section 1(2) of CTA 2009. This means corporations must calculate their profits separately according to the following activities:

Trading (CTA 2009 Part 3)
Land (property business) (CTA 2009 Part 4)
Debt claims (loan relationships) (CTA 2009 Parts 5 and 6)
Derivatives (CTA 2009 Part 7)
Intangibles (CTA 2009 Part 8)
Know-how and patents (CTA 2009 Part 9)
Dividends (CTA 2009 Part 9A)
Miscellaneous income (CTA 2009 Part 10)
Disposal of capital assets (TCGA 1992)

This schedular system produces a significant divorce between a corporation's financial accounts and its tax base. Unlike the other global systems, it means that the system requires reconciliation rules where a particular receipt or expense might otherwise simultaneously fall under two or more heads of charge. These reconciliation rules are confusing, fragmented, difficult to find and unnecessarily complex. Broadly, they involve (at least by comparison to trading):

* Property business has priority over trading.[220] However, except in the context of a trade, the loan relationship rules have priority over property business and the same applies with respect to derivatives.[221] By contrast, property business has priority over the intangible assets regime.[222]

[217] CTA 2009 (UK) s. 8(5).
[218] CTA 2009 (UK) s. 9.
[219] CTA 2009 (UK) s. 2(2).
[220] CTA 2009 (UK) s. 201.
[221] CTA 2009 (UK) s. 211.
[222] CTA 2009 (UK) s. 748.

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* The loan relationship rules have general priority.[223] However, credits and debits for the purposes of trade are accounted for under the trading head.[224] In addition, distributions generally have priority over loan relationships.[225]
* Credits and debits on derivative contracts for the purposes of trade are accounted for under the trading head.[226] Otherwise, most non-trading debits and credits from derivative contracts are dealt with under the loan relationship rules.[227]
* Similarly, credits and debits under the intangible assets regime used for the purposes of trade are accounted for under the trading head.[228] However, unlike derivative contracts, non-trading gains on intangible fixed assets are subject to their own charge.[229]
* Trade has priority over the charge on profits from disposal of know-how.[230] Profits on the disposal of patent rights are calculated only using capital amounts.[231] Under either head, as long as the asset in question (if there is one) is used for commercial purposes and was acquired post-2002, it seems (though not clearly) the intangible assets regime applies.[232]
* Trade and property business have priority over distributions,[233] but distributions generally trump loan relationships (above).
* Miscellaneous income is subject to trading and property business.[234] Annual payments and other income are expressly residual in nature.[235]
* Normal reconciliation rules apply for capital gains. Amounts included in income are excluded from consideration received on disposal and amounts deductible from income are excluded from the cost base of an asset.[236]

This has been set out in longhand to demonstrate how a country can let a schedular system get out of control. The UK's is far from the approach

[223] CTA 2009 (UK) s. 464.
[224] CTA 2009 (UK) s. 297.
[225] CTA 2009 (UK) s. 465.
[226] CTA 2009 (UK) s. 573.
[227] CTA 2009 (UK) s. 574.
[228] CTA 2009 (UK) s. 747.
[229] CTA 2009 (UK) s. 752.
[230] CTA 2009 (UK) s. 909.
[231] CTA 2009 (UK) s. 913.
[232] CTA 2009 (UK) ss. 803, 881 and 906.
[233] CTA 2009 (UK) s. 931W.
[234] CTA 2009 (UK) s. 982.
[235] CTA 2009 (UK) ss. 977 and 979, respectively.
[236] TCGA 1992 (UK) ss. 37 and 39, respectively.

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that would be taken in financial accounts. However, just as a global system doesn't mean a relationship between financial accounting and the tax base, the UK schedular system doesn't mean there is no such relationship. To find that relationship, it is necessary to investigate each of these heads of charge. First, it is useful to investigate how the schedular or global system interfaces with losses and whether a corporation tax base should follow financial accounts.

1.2.1.2 Use of Losses

One area in which corporate tax treatment fundamentally depends on whether a global or schedular approach is adopted is in the use of losses. This is particularly so with respect to the manner in which losses may be used in the year in which they are incurred. However, this can also be the case if a loss incurred in one year can be carried backwards to set against the profits of a previous year or carried forward to set against profits of a future year. Carry back of losses usually involves the refund of taxes paid in a previous year and so this type of relief is often restricted or not available at all. By contrast, carry forward of losses is typical and the issues are rather for how long the losses may be carried forward and set off against what types of income and to what extent. The use of losses is not just important in the context of a single corporation and whether a global or schedular approach is used. It is also necessary background to the use of losses within corporate groups, which is considered below at 1.2.3.2.

Use in Year in Which Incurred As mentioned, the manner in which a corporation may use a loss in the year in which it is incurred depends on whether the income tax law in question adopts a global or a schedular approach to calculation of the corporation tax base. For example, Germany adopts a global approach with respect to corporations and so needs no express rule that losses from one activity may offset profits from another.[237] The same is true in China. In both cases, this also means that capital losses are generally deductible and not quarantined.

Despite also adopting a general global approach, the US treatment of current year losses is slightly more complex. This is because the global approach is partly schedularised through the quarantining of certain losses under section 165 of IRC. Further, as noted above, 'losses from sales

[237] For example, see EStG (Germany) s. 10d(1) referring to losses 'set off upon determination of the total income'.

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or exchanges of capital assets shall be allowed only to the extent of gains from such sales or exchanges'.[238]

The UK position is again complicated by the schedular nature of its corporation tax base. Just as it is possible to have income or profits with respect to each schedular activity, it is possible to have a loss with respect to many such activities. The UK has rules specifying when a person with a loss from one activity may set that loss against the profits that the person derives from another activity. This is commonly referred to as 'sideways' relief.

For example, if a company makes a loss in carrying on a trade during an accounting period, the company may claim to set that loss against its total profits of that accounting period.[239] Losses of a trade are computed in the same way as income from the trade.[240] This is important because it means that losses of a trade are only revenue losses. Capital losses are dealt with under TCGA 1992. 'Total profits' is the aggregate profits of a corporation subject to corporation tax. It includes all types of income as well as capital gains. So, trading losses can be set against any income or capital gains of the corporation of the accounting period in which the loss is incurred.

Losses from a UK property business can also be set against a company's total profits.[241] Capital losses can be carried forward indefinitely and set against any type of capital gain.[242] This means that capital losses cannot be deducted in calculating income, that is, they are quarantined, similar to the position in the US.

Carry Back If a loss incurred by a corporation cannot be absorbed in the year in which it is incurred, a tax law may permit that loss to be carried backwards to reduce the profits of previous years. Many countries do not permit this treatment, which often involves the refund of taxes paid in previous years. For example, the Chinese income tax law incorporates no provision for the carry back of losses.

Countries that do permit loss carry back often restrict loss carry back when lowering corporate tax rates. Germany is a good example. Optionally, Germany permits corporate losses to be carried back for two years and in

[238] IRC (US) s. 1211(a). Also see the text below accompanying footnote 293.
[239] CTA 2010 (UK) s. 37. Relief against total profits is not available for losses of a wholly overseas trade; s. 37(5).
[240] CTA 2009 (UK) s. 47.
[241] CTA 2010 (UK) s. 62.
[242] TCGA 1992 (UK) s. 2A.

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doing so places a financial limit on the amount of carry back.[243] Losses are used against profits of the immediately preceding year before the second preceding year. The carry-back limit is €1,000,000, which means the carry back is less useful for larger corporations. By contrast, the US historically permitted a carry back of two years without such a limitation. However, since the Trump tax reforms of 2017 and with a slight reprieve for Covid, there is currently no carry back.[244] An exception is capital losses, which may be carried back for three years.[245]

In the UK, trading losses incurred by a corporation in a particular accounting period may be set against the total profits of the corporation of the previous accounting period, that is, one-year carry back.[246] There is a special three-year carry back for losses incurred in the year in which a trade is terminated.[247] By contrast, a loss from a UK property business cannot be carried backwards. There is also no carry back of capital losses.

Carry Forward If a loss cannot be used in the year in which it is incurred or carried backwards, most income tax laws permit at least some types of losses to be carried forward. Historically, the period for which losses could be carried forward was limited and this is still the case in many middle or low-income countries. Of the countries under consideration, China still adopts this approach. Losses (whether capital or revenue) incurred by an enterprise may be carried forward to reduce income of the five years following the year in which the loss was incurred.[248] For those five years, there is no limit on the amount of income that may be reduced by a loss.

The current value of a loss decreases as the use of the loss against profits is projected further and further into the future. This means that lifting a limit on the period of carry forward may not be so costly and can simplify the treatment of losses by cutting down on recording and ordering rules. As a result, permanent loss carry forward is common, although many countries impose some type of limit on use of carried forward losses. Germany has unlimited loss carry forward, but in 2004 introduced a measure known as the 'minimum tax' to restrict the rate at which carried forward losses may be used. When a German corporation

[243] EStG (Germany) s. 10d(1).
[244] IRC (US) s. 172.
[245] IRC (US) s. 1212(a)(1)(A).
[246] CTA 2010 (UK) s. 37.
[247] CTA 2010 (UK) s. 39.
[248] EITL (China) Art. 18.

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seeks to use a loss carried forward from a previous year, it may unrestrictedly reduce its profits by a total of €1 million of that loss. If it wishes to reduce its profits by any more than this amount, the deduction is limited to '60% of the total amount of income exceeding the €1 million'.[249] Any unused losses may still be carried forward in full, that is, the measure does not cancel losses. This provision has proved controversial, it is often argued that it discriminates against start-up businesses with losses. It also causes taxpayers with carried forward losses to monitor their taxable income so that the full €1 million is used each year. In particular, it may be sensible for a corporation with losses to accelerate the recognition of income in some years.

Historically, the US limited the carry forward of net operating losses to 20 years. This limit was lifted in the Trump tax reforms. Losses incurred after 2017 may be carried forward indefinitely.[250]. However, at the same time the amount of post-2017 losses that can be deducted was limited to 80 per cent of taxable income.[251] Confusingly, capital losses are still subject to a five-year carry-forward limit.[252] There seems little rationale for the inconsistency.

The UK typically allows permanent carry forward of unused loses. So, if a corporation cannot obtain relief for a trading loss in either the current accounting period or the previous accounting period, the loss may be carried forward indefinitely. However, historically the UK quarantined carried forward trading losses so that they could only be set against profits of the same trade that made the loss.[253] This rule still applies to losses incurred before 2017 but trading losses incurred from that year can be carried forward to set against total profits of a future tax year, that is, the quarantining was lifted.[254] However, with incredible complexity, from 2017 the UK introduced a German-like limitation on the use of carried forward losses. These may only be deducted in full from total profits up to £5 million and after that are limited to 50 per cent of total profits.[255]

As for other types of losses, carried forward losses from a UK property business can be set against a corporation's total income and not just its

[249] EStG (Germany) s. 10d(2).
[250] IRC (US) s. 172(b)(1)(A).
[251] IRC (US) s. 172(a).
[252] IRC (US) s. 1212(a)(1)(B).
[253] CTA 2010 (UK) s. 45.
[254] CTA 2010 (UK) s. 45A.
[255] CTA 2010 (UK) s. 269ZD. Much of the complexity results from trying to allocate the £5 million threshold between members of corporate groups.

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income from that business.[256] The property business must continue for the losses to be used in this manner. This is not such a high threshold because, in contrast to the various trades that a corporation may have, all a corporation's income-generating activities from UK land constitute one single property business.[257] Capital losses can be carried forward indefinitely and set against any type of capital gain. There is no requirement that any particular activity be continued. However, as a general rule, capital losses cannot be deducted in calculating income, that is, they are quarantined.[258] All of these types of losses are subject to the same 50 per cent rule mentioned in the last paragraph, with complex rules to allocate the £5 million threshold between the use of revenue and capital losses.[259]

1.2.1.3 Should the Corporation Tax Base Follow Financial Accounts?

There is a substantial amount of academic literature debating whether and to what extent the corporation tax base should follow financial accounts.[260] The following short discussion seeks to summarise that debate rather than contribute to it. An income tax law should take an explicit position on the relevance of financial accounts in determining the tax base, particularly the corporation tax base. Unfortunately, as income tax law developed much earlier than the first release of accounting recommendations in the 1930s (US) and 40s (UK), the approach is typically fragmented.

The main options for a relationship in law between the corporation tax base and financial accounting are:

- (i) corporation tax base mirrors the financial accounts (correlation);
- (ii) corporation tax base mirrors the financial accounts, but in specific cases the tax law overrides the accounts;
- (iii) as for (ii), but any adjustment made by reason of the tax law must be reflected in the financial accounts (reverse correlation);
- (iv) no direct relationship, but an indirect ad hoc relationship when the tax law fails to prescribe rules; or
- (v) no relationship.

[256] CTA 2010 (UK) s. 62.
[257] CTA 2009 (UK) s. 205.
[258] TCGA 1992 (UK) s. 2A.
[259] CTA 2010 (UK) s. 269ZF.
[260] Much of this literature is referenced in Schön (2008), especially Part 2. Harris (2015) assesses the relationship between the International Financial Reporting Standards ('IFRS') and the structural features of income tax law. For a recent US consideration, see Herzfeld (2020) and Herzfeld (2020b).

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Options (i) and (v) are extremes that do not exist to an identifiable extent in practice. Option (iii) is also rare and does not exist in countries like the UK and the US where accounting standards are not prescribed by law. This means that in the vast majority of countries accounts prepared for corporate tax purposes differ from financial accounts. Divergence in approach adopted by countries is, therefore, primarily a matter of whether the tax law starts with the financial accounts and makes adjustments or starts with a formulaic tax base and accepts that accounting treatment may be relevant at points. There is also the issue of the extent of divergence or convergence.

As mentioned, historically it was not possible for income tax law to follow financial accounts. Income tax law, at least in the UK, was introduced long before the registered company and even longer before registered companies were required to prepare and file accounts.[261] In any case, prior to the twentieth century and well into it accounting remained very discretionary, inconsistent and under-developed; an inappropriate mix for adoption as a tax base.[262] In the last four decades, accounting has developed dramatically. It is more robust, sophisticated and accurate. Nevertheless, many argue that there are features of accounting standards and the manner in which they are set that make them inappropriate for holistic adoption as a tax base.[263] The following discussion briefly considers the main arguments.

A tax law should be certain and, therefore, precise in calculating a person's income. As a matter of fairness, taxpayers should not have a choice as to how much income they declare, that is, there should be one, *correct* amount of taxable income. This is also necessary for certainty, that is, a taxpayer should know what the tax consequences of a transaction will be before the taxpayer enters into it. In many cases, accounting rules accept a range of results for particular transactions and positions. The sort of discretion that is left to the accountant is viewed as unacceptable and so financial accounts are inappropriate for holistic adoption as a tax base.

[261] The UK first prescribed registration of companies by the Joint Stock Companies Act 1844 (UK). Preparation and publication of financial statements was first prescribed by the Companies Act 1862 (UK) s. 42. It only applied to banking and insurance companies. The statement was to follow Form D of the First Schedule and simply involved a statement of assets and liabilities.

[262] For an overview of the development of accounting and its relationship with direct taxation in the UK before 1820, see Harris (2006).

[263] After evaluating the utility of adopting parts of IFRS for the purposes of structuring an income tax law, Harris (2015, 95) concludes that the 'overwhelming impression is that while IFRS might be useful in some situations, those situations tend to be narrow and focused'.

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This point is graphically illustrated by the UK *Union Castle Mail Steamship* case.[264] A subsidiary issued shares carrying with them the right to 95 per cent of the cash flow from certain derivatives contracts. As a result, the subsidiary derecognised the contracts in its financial accounts creating a loss. The question was whether this loss should be recognised for tax purposes. There was no dispute that the recognition of the loss complied with financial accounting principles. Effectively, the taxpayer was trying to use financial accounting to manufacture a tax deduction for dividends.

The purposes for which accounts are prepared are inconsistent with or at least different from the reasons why a person must declare income. Accounts are prepared for investor and public consumption and, as a result, conservatism (prudence) can be important. Historically, this involves not overstating profits and so may involve anticipating losses but not profits.[265] This may be viewed as inconsistent with the principle of equity in taxation, which involves a fair sharing of taxation between people based on a consistent and balanced calculation of their income. In tax law, the focus should be on accuracy in comparing positions so as to promote fairness.

The Accounting Standards Board, which issues UK accounting standards, the Financial Accounting Standards Board, which issues US accounting standards, and the International Accounting Standards Board, which issues the International Financial Reporting Standards, are independent authorities.[266] They seek to act in an autonomous and dynamic

[264] Union Castle Mail Steamship Co Limited v. RCC [2020] EWCA Civ 547 (CA).

[265] This is well demonstrated by Commercial Code (HGB) (Germany) s. 252(1)4. Under the IFRS 'Conceptual Framework for Financial Reporting' (2018 revision), 'faithful representation' is a fundamental characteristic of financial information. Faithful representation has three characteristics including 'neutrality', and 'neutrality is supported by the exercise of prudence'. See [2.12] to [2.16]; available at https://bit.ly/3RNCwjh, accessed 15 June 2023. Prudence has also returned as a characteristic of accounting policy in the UK; see Financial Reporting Standard FRS 102 [2.9], available at www.frc.org.uk/accountants/accounting-and-reporting-policy, accessed 15 June 2023. Similarly, the principle of prudence appears in China's 'Accounting Standards for Business Enterprises – Basic Standards' Art. 18; available at www.casplus.com/rules/rules.asp#newas, accessed 15 June 2023; and see Barhamzaid (2019). However, under US GAAP prudence (conservativism) is not considered part of the characteristic of 'faithful representation' for fear that 'an admonition to be prudent is likely to lead to bias', see 'Statement of Financial Accounting Concepts No. 8' [BC3.28] and also at [BC3.19]; available at www.fasb.org/home, accessed 15 June 2023.

[266] Apparently (but not clearly), this is true of the German Accounting Standards Committee, which, in accordance with the Commercial Code (HGB) Art. 342, is contractually bound with the Federal Ministry of Justice regarding the setting of accounting standards. See www.drsc.de/en/about/, accessed 15 June 2023.

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manner in developing accounting standards. If those standards were the sole basis for determination of taxable income, the government and the tax administration would have a direct interest in the setting of those standards. Interference from the government and the tax administration might reduce the flexibility of setting accounting standards and compromise accuracy. It might also confuse the purposes for which accounting standards are made. By contrast, the China Accounting Standards Committee is a consultative body within the Accounting Regulatory Department of the Ministry of Finance and so does not possess the same level of autonomy.[267]

Finally, given the independent nature of the accounting standards setting bodies, there is a question of accountability. If tax law follows financial accounts, these bodies would have an ability to alter the tax base by altering their standards. Responsible government suggests that such a power should be exercised only by the legislature.

Proponents of using accounting standards do not dispute these points so much as take the view that they do not overbalance the convenience and efficiency of using financial accounts as a tax base. Here the suggestion is that there is sufficient (though not complete) consistency of purpose. The government retains the power to override accounting standards should they develop in an obscure manner that makes them inappropriate as a tax base. As a result, there is no reason for the government to become directly involved in setting accounting standards. Nevertheless, the government remains responsible for the choice of adopting accounting standards as the tax base and must monitor that adoption on a continuing basis.

1.2.1.4 Relationship with Accounting in Practice

As mentioned, the vast majority of countries accept a relationship between the corporation tax base and financial accounts, but do not holistically accept financial accounts. The relationship tends to be closest in civil law jurisdictions, which have a greater propensity to use financial accounts as the starting point for calculating the corporation tax base. Common law jurisdictions are less likely to use this starting point, although these jurisdictions do use accounting treatment to fill holes in the absence of legislative rules. One reason for this approach in common law jurisdictions is the exclusion or quarantining of capital gains from the income tax base.

[267] See https://bit.ly/46klkGD, accessed 15 June 2023. Accounting Law (China) Art. 7 specifically requires the Ministry of Finance to administer standardisation of accounting.

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Capital gains are an area in which the corporation tax base is likely to diverge from accounting treatment, at least in common law jurisdictions. There are a number of other areas of common divergence, of which depreciation is the leading example.[268] The tax laws of many countries provide for accelerated rates of depreciation when compared with accounting treatment. In addition, some countries, including the UK, refuse to grant any write down for some types of depreciating assets. Other areas of divergence include trading stock valuation, provisioning, inflation adjustments, long-term contracts (including leasing), interest, foreign currency transactions, pensions, fines, charitable donations, entertainment expenses and losses.[269]

The matters listed in the last paragraph are general tax base issues. The tax laws of many countries incorporate special rules, especially concessions, and sometimes these special rules are targeted at corporations. Special rules may involve the provision of investment tax credits and export or research and development incentives. Some countries have special regimes for headquarter companies, financial services and various other matters or simplified rules for calculating the tax base of small- and medium-sized businesses (discussed below at 1.2.5). Many countries also have special regimes for group corporations (see discussion below at 1.2.3).

The increased importance of fair value accounting creates another potential dislocation between the corporation tax base and financial accounts, particularly where that base requires realisation. The International Accounting Standards Board was formed in 2000 and since that time the scope for use of fair value accounting has been broadened. This is especially so since the adoption of International Financial Reporting Standards for EU listed corporations in 2005.[270] However, the use of fair value accounting as a point of divergence with the corporation tax base should not be overstated. At present, that method of

[268] Harris (2015, 97) concludes that 'IFRS is a hybrid between historical cost and fair value accounting. Income tax law also has hybrid aspects of this nature, but the major hybrid nature of the income tax is between being a tax on income and a tax on expenditure. Not surprisingly, the areas in which an income tax law demonstrates some major departures from IFRS (e.g. accelerated depreciation and full deduction of financing expenses) is where it incorporates some of the features of an expenditure tax.'

[269] For a comparative analysis of these issues from the perspective of 11 different countries (including China, Germany, the UK and the US), see Arnold, Ault & Cooper (2019, Part Two).

[270] Application of International Accounting Standards, Council Regulation (EC) No 1606/2002.

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accounting tends to be used only in the areas of financial instruments and investment property of real estate businesses.[271] Some income tax laws accept or require fair value accounting in these areas or explicitly prescribe rules that are not dissimilar.[272] Generally, historical cost accounting continues to dominate, particularly in the valuation of plant, equipment and intangible assets.

Germany is a good example of a country where there is a close correspondence between the corporation tax base and financial accounts, although historically it was closer. As mentioned above, Germany effectively adopts a global approach to the corporation tax base because all income is considered as business income. Under the Income Tax Law, this is determined as 'profit' from business activity.[273] 'Profit' is defined as 'the difference in amount between the business assets at the close of the accounting period and the business assets at the close of the preceding accounting period'.[274] Section 5(1) is particularly important:

> In the case of traders who … are required to keep books and prepare financial statements regularly … the business assets must be evaluated … [and] recorded according to the commercial law generally accepted accounting principles, unless a different adjustment is or has been chosen in accordance with the elections provided under tax law.

So, the corporation tax base corresponds to financial accounts (principle of correlation), unless the tax law provides an election to the contrary. Before 2009, there was also a principle of reverse correlation whereby an election under a tax law provision was required to be reported in the financial accounts. The amendments were made when International Financial Reporting Standards became generally available in Germany in 2009.

In China, there is also a close correlation between financial accounts and the corporation tax base. The formulaic legal mechanics for calculating taxable income on a global basis were outlined above in the discussion of its global approach. The EITL proceeds to specify that income, deductions and treatment of assets under the enterprise income tax are to be determined by the Ministry of Finance and the tax

[271] Generally regarding fair value accounting, its use in Europe and the US and its role in the 2008 financial crisis, see Laux & Leuz (2009). At p. 827 they note that '[u]nder both US GAAP and IFRS, fair values are most frequently used for financial assets and liabilities'.

[272] For examples, see Arnold, Ault & Cooper (2019, 418–25).

[273] EStG (Germany) s. 2(2)1.

[274] EStG (Germany) s. 4(1).

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administration.[275] As the Ministry of Finance is also responsible for setting accounting standards, this means that taxable income for enterprise income tax purposes is based on financial accounts.[276] However, where the accounts are not consistent with a legal or administrative regulation, 'the tax law or administrative regulation shall prevail'.[277] In particular, and as in Germany, this means that there is no capital/revenue distinction in China and so capital gains derived by a corporation are taxed in the same manner as revenue gains.

As noted above, the relationship between the UK corporation tax base and financial accounts is complex and fragmented. To understand this relationship, it is necessary to investigate each of the schedular heads of charge to corporation tax. There are some heads where there is no connection or no obvious connection. This is the case with the charge on capital gains. TCGA 1992 is prescriptive about how chargeable gains are calculated and its rules leave little if any scope for the application of accounting treatment. Likewise, it is difficult to see any substantial role for accounting practice in the context of the charge on know-how, patents, dividends or miscellaneous income. These are, however, minor heads of charge by comparison to the other heads of charge.

The most substantial connection in the UK between the corporation tax base and financial accounts is in the charge on trading income. Section 35 of CTA 2009 charges to corporation tax 'on income' the 'profits of a trade'. This formulation is every bit as quirky as it appears. The reference to 'profits' suggests a connection with accounting, but simultaneously the reference to 'income' suggests a judicially developed concept that distinguishes income from capital. This latter aspect is dealt with explicitly by sections 53 and 93. Capital expenditure is not deductible and capital receipts are not includible in calculating the profits of a trade, respectively. The treatment of these types of payments is largely reserved for CAA 2001 and TCGA 1992. This produces a large dislocation between the profits of a trade and a corporation's financial accounts (especially in the context of depreciable assets), even where the corporation's sole activity is one trade.

However, with respect to revenue (income) amounts, there is a presumption that accounting treatment should be followed, at least residually. Section 46(1) of CTA 2009 provides:

[275] EITL (China) Art. 20.
[276] Arnold, Ault & Cooper (2019, 70) and Wei Cui (2023, 11).
[277] EITL (China) Art. 20.

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> The profits of a trade must be calculated in accordance with generally accepted accounting practice, subject to any adjustment required or authorised by law in calculating profits for corporation tax purposes.

'Generally accepted accounting practice' is defined by reference to section 1127 of CTA 2010. For companies using International Financial Reporting Standards, this is as prescribed by those standards.[278] Residually, 'generally accepted accounting practice' means accounting practice intended to give a 'true and fair view'. Section 393 of the Companies Act 2006 requires directors to be satisfied that their company's annual accounts give a true and fair view. Section 396 of that Act goes on to specify the nature of a company's individual accounts, but most of the detail is left to regulations.[279] While the legislation could be clearer, it is accepted that the requirement of a true and fair view is an indirect reference to Financial Reporting Standards issued by the Financial Reporting Council.

Even when the relevant standards are identified in accordance with this convoluted procedure, section 46(1) of CTA 2009 overrides those standards with 'any adjustment required or authorised by law'. It is clear that specific statutory provisions override accounting practice, such as the non-recognition of capital expenditure and receipts in sections 53 and 93. A major issue has been the extent to which 'law' includes case law. While conceptually tax cases always involve the interpretation of statute, at a more practical level courts have often filled gaps in tax legislation. It is not clear to what extent changes in accounting practice can supersede earlier judicial pronouncements filling gaps. This thorny issue was addressed by the Supreme Court in 2022:

> Tax is the creature of statute and … adjustments required or authorised to be made to profits calculated in accordance with generally accepted accounting principles are likely to be adjustments specified by statute. While it is possible for a judge-made rule to require or authorise such an adjustment to be made, it would have to be a rule which it is clear applies notwithstanding that the company's profits have been calculated in accordance with generally accepted accounting principles.[280]

[278] CTA 2010 (UK) s. 1127 referring to *Application of International Accounting Standards*, Council Regulation (EC) No 1606/2002.

[279] See the Small Companies and Groups (Accounts and Directors' Report) Regulations 2008 (SI 2008/409) (UK) and Large- and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008 (SI 2008/410) (UK).

[280] *RCC* v. *NCL Investments Ltd* [2022] UKSC 9 (SC) at [29].

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The rule in question did not meet this test. Tension in this area has been reduced in recent years through a practice of legislating judicial rules thought appropriate.[281]

As for other heads of charge with a connection to accounting practice, income from land (property business) is calculated using the rules for trading profits.[282] In particular, the requirement to follow generally accepted accounting practice in section 46(1) of CTA 2009 is adopted for property business. The connection is more direct in the loan relationship provisions, where amounts are credited and debited in accordance with generally accepted accounting practice.[283] This practice may be overridden by express provisions in the loan relationship rules, but there is no general rule excluding capital expenditure or receipts from recognition. A similar approach is adopted with respect to derivatives and intangibles.[284] Despite these connections, the courts do not slavishly follow accounting rules. In the *Union Castle Mail Steamship* case (discussed above), the Court of Appeal held that the derecognition of the derivatives by the subsidiary was a 'loss' within the meaning of the legislation (because of following of accounting principles), but that the loss did not 'fairly represent' a loss to the subsidiary, that is, it used vague legislative terminology to override accounting principles.[285]

While the US has a global corporation tax base, the linkage with financial accounting is even weaker than in the UK. Indeed, as a result of the basic tax base formula (gross income minus allowable deductions) there is no express legislative link at all.[286] US tax law prescribes that '[t]axable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books'.[287] However, this is not a direct reference to generally accepted accounting principles and the section goes on to provide for overriding the taxpayer's books. At a deeper level there are some connections

[281] For example, the non-inclusion of capital receipts under CTA 2009 (UK) s. 93 and the enactment of *Sharkey* v. *Wernher* [1956] AC 58 (HL) in CTA 2009 (UK) s. 157.

[282] CTA 2009 (UK) s. 210.

[283] CTA 2009 (UK) ss. 308 and 309.

[284] CTA 2009 (UK) ss. 597 and 599 (derivatives) and 716 and 717 (intangibles).

[285] *Union Castle Mail Steamship Co Limited* v. *RCC* [2020] EWCA Civ 547 (CA). In this regard the court followed *GDF Suez Teesside Ltd* v. *RCC* [2018] EWCA Civ 2075 (CA) which concerned an equivalent provision in the loan relationship rules.

[286] For example, see Arnold, Ault & Cooper (2019, 262). In *Thor Power Tool* v. *Commissioner* (1979) 439 U.S. 522, 542–3 (Sup Crt) the US Supreme Court recognised that it would be inappropriate to align tax accounting and financial accounting.

[287] IRC (US) s. 446(a).

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between financial accounting and the corporation tax base and 'ordinarily' accounting principles are regarded as 'clearly reflecting income'.[288] For example, 'gross income derived from business' is understood to mean gross profits, not gross receipts. So, it includes sales proceeds less cost of goods sold and 'the cost of goods sold should be determined in accordance with the method of accounting consistently used by the taxpayer'.[289]

Gross income also has a head for 'gains derived from dealings in property', which are generically included in the calculation of taxable income under the global approach.[290] However, the IRC does provide for separate calculation of gains and losses from capital assets.[291] 'Capital asset' is defined to exclude trading stock, depreciable assets and certain other items.[292] As in the UK, losses of a corporation from the disposal of capital assets are quarantined so that they may only be set against capital gains.[293]

In contrast to this position with the regular corporate income tax base, from the start of 2023 the US added a feature that is directly based on financial statements in the form of the corporate alternative minimum tax.[294] This tax is imposed on 'applicable corporations' with 'adjusted financial statement income' exceeding $1 billion averaged over three years,[295] which means it is likely to reach about 150 of the world's largest multinational corporations.[296] The starting place for the tax base is 'income or loss of the taxpayer set forth on the taxpayer's applicable financial statement'.[297] There are complex tax law adjustments to the financial statement, including in how income of group members, foreign income,

[288] Title 26 Code of Federal Regulations (US) § 1.446-1(a)(2).
[289] Title 26 Code of Federal Regulations (US) § 1.61-3(a).
[290] IRC (US) s. 61(a)(3). IRC (US) Subchapter O contains general rules regarding calculation of gains and losses on the disposal of property.
[291] IRC (US) Subchapter P (ss 1201–1298).
[292] IRC (US) s. 1221.
[293] IRC (US) s. 1211(a).
[294] This tax is not to be confused with the earlier alternative minimum tax applicable to corporations discussed in the previous edition of this book, which was repealed by the Trump tax reforms of 2017.
[295] IRC (US) ss. 55(a) and (b) and 59(k)(1).
[296] See Sullivan (2022) on corporations that are likely to pay this tax. Joint Committee on Taxation (2023, 21) estimates that for 2023 150 corporations will pay alternative minimum tax of $35 billion.
[297] IRC (US) s. 56A(a). Under subsection (b), the starting place for identifying an applicable financial statement is one that is required to be filed with the Securities Exchange Commission.

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foreign tax, depreciation and losses are dealt with.[298] There is also a broad power to make regulations that may take the tax base further from the financial statement.[299]

Similarly, the base of the OECD's global minimum tax model rules released in December 2021 to implement Pillar Two of the BEPS II project starts with consolidated accounts of multinational groups. 'Net Income or Loss is the net income or loss determined for a Constituent Entity … in preparing Consolidated Financial Statements of the Ultimate Parent Entity'.[300] Article 3 goes on to provide for important adjustments to this amount.[301] These rules have been further detailed in OECD Commentary, which appears to provide fertile ground for further adjustments and greater deviation from the accounts.[302] Unlike the US rules, these OECD rules only apply where at least one member of the group or a PE of a member is in a different country to the parent.[303] The target of these rules is cross-border tax base erosion and consequently further consideration of these rules and their implementation in domestic tax laws are beyond the scope of this book, but see below at 3.2.2.1.

1.2.2 Reinforcement of Corporate Identity: Transfer Pricing

As discussed above at 1.1.4.3, a corporate tax system may respond to a concentration of ownership and control of a corporation by reinforcing the separate identity of that corporation. The primary mechanism for reinforcing the separate identity of controlled entities is the imposition of the arm's length approach to transfer pricing. This section focuses on transfer pricing treatment in a domestic context. It is not concerned with international aspects of transfer pricing or arm's length pricing methodology.[304]

'Transfer pricing' is, not surprisingly, concerned with the price at which resources are transferred, especially between related parties. Here, the arm's length approach is commonly adopted, although it may be expressed in different forms. The application of the arm's length standard

[298] IRC (US) s. 56A(c) and (d).
[299] IRC (US) s. 56A(c)(15).
[300] OECD (2021) Art. 3.1.2.
[301] OECD (2021) Art. 3.2.
[302] OECD (2022).
[303] OECD (2021) Art. 1.2.1.
[304] Generally regarding these matters, see Harris (2020, [3.3.1]) and the references cited therein. For comparison of arm's length transfer pricing rules and market value rules, see Wittendorff (2012).

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means that the actual transaction price is not accepted for tax purposes and so, as arm's length pricing is an exception to the general approach, the scope of application of the rule needs to be delineated. This will involve identifying the relevant relationship required between the parties in order to trigger the arm's length rule. For this purpose, as discussed above at 1.1.5, there may be attribution of rights to particular persons for the purposes of determining if the relevant relationship is met. Further questions involve whether the arm's length price applies to both parties of a transaction (corresponding adjustments) and whether any tax consequences attach to payments made to bring the transaction price into line with the arm's length price (subvention payments).

1.2.2.1 Arm's Length Pricing

In many countries, especially common law jurisdictions, transfer pricing rules have been largely confined to cross-border transactions. This was the approach of the UK until 2004. Where transfer pricing rules do not apply, a primary question to be asked regarding pricing of transactions between related parties is whether expenses fall within any general limitations on deduction of expenses. For example, deductions may be denied where a business purpose is lacking.[305] If an expense is largely an effort to manipulate who derives income as between related parties, it may not meet this test and, therefore, not be deductible.[306] A deduction may also be denied if a payment constitutes a hidden profit distribution or hidden capital contribution, for example, see below regarding Germany.

Many countries, however, apply their transfer pricing rules to both domestic and cross-border transactions. This is the case with the US's general transfer pricing provision:

> In any case of two or more organisations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary may distribute, apportion, or allocate gross

[305] In China, 'reasonable expenses' incurred which have a 'connection with the business operations' may be deducted; EITL (China) Art. 8. Further restrictions are imposed by EITR (China) Arts 27–55. In Germany, expenses are generally deductible if 'incurred as a result of the business operations'; EStG (Germany) s. 4(4). In the UK, trading expenses can be deducted only if they are incurred 'wholly and exclusively for the purposes of the trade'; CTA 2009 (UK) s. 54(1) and ITTOIA 2005 (UK) s. 34(1). In the US, expenses are deductible if they are 'ordinary and necessary expenses paid or incurred … in carrying on any trade or business'; IRC (US) s. 162(a).

[306] For a discussion of the UK rule in the context of expenses incurred by a family company in favour of a family member, see Harris & Olivier (2008, 254–62).

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> income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that … necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses.[307]

This relatively short provision is supplemented with extensive regulations. These regulations make it clear that in 'determining the true taxable income of a controlled taxpayer, the standard to be applied in every case is that of a taxpayer dealing at arm's length with an uncontrolled taxpayer'.[308] The regulations go on to specify various methods by which an arm's length price may be established. In broad outline, these are similar to those used by the OECD for purposes of the OECD Model. The regulations define, for the purposes of the regulations, many of the terms and phrases used in section 482.[309]

Similarly, China adopts a singular approach to transfer pricing. Transactions between affiliated parties that reduce income by 'virtue of the failure to conform to the arm's length principle' empowers the tax administration to 'through a reasonable method, make an adjustment'.[310] This provision is supplemented with regulations which makes clear that all enterprises are subject to the rules, whether resident or non-resident.[311]

Germany's approach is somewhat fragmented. In its Foreign Tax Law, it adopts the arm's length standard in terms not dissimilar to the OECD Model.[312] However, the German provision goes on to incorporate some specifics as to transfer pricing methodology, rather than directly incorporating the OECD Transfer Pricing Guidelines (the guidelines remain indirectly relevant). The scope of this provision is limited to a 'foreign business relationship with an associated person'.[313] The German Federal Finance Court has held that the Foreign Tax Law provision cannot apply, even by analogy, to domestic relations between two resident corporations.[314] In domestic situations, transfer pricing adjustments may be made only under the vague concepts of hidden profit distribution and hidden capital

[307] IRC (US) s. 482.

[308] Title 26 Code of Federal Regulations (US) § 1.482-1(b)(1).

[309] Title 26 Code of Federal Regulations (US) § 1.482-1(i).

[310] EITL (China) Art. 41.

[311] EITR (China) Arts 109–15.

[312] Foreign Tax Law (*Außensteuergesetz*, AStG) (Germany) s. 1.

[313] However, see Foreign Tax Law (AStG) (Germany) s. 1(3b) regarding attempts to shift certain forms of profit potential offshore.

[314] See Endres & Miles (2004). Also see Eigelshoven & Limpinsel (2022, [2.4]).

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contribution. These concepts are largely based on case law (see below at 2.2.2) and neither is defined in detail in German Income Tax Law.[315]

The UK approach is even more fragmented and again the capital/revenue distinction is a primary source of this. In 2004, the UK extended its primary transfer pricing rules to domestic transactions as a response to a decision of the CJEU.[316]. These rules now appear in Part 4 of TIOPA 2010.[317] They are long and detailed, perhaps unnecessarily so. In essence, they also draw heavily from the OECD Model. The UK rules are triggered where a transaction is made between related persons, the transaction is not at arm's length and the transaction confers a benefit in relation to UK tax. Where these conditions are met, the 'profits and losses of the potentially advantaged person are to be calculated for tax purposes as if the arm's length provision had been made or imposed instead of the actual provision'.[318] What constitutes an arm's length provision is to be determined consistently with the OECD Transfer Pricing Guidelines.[319]

The TIOPA 2010 transfer pricing rules incorporate an important exception. They do not apply if the potentially advantaged person is a small- or medium-sized enterprise.[320] Confusingly, the transfer pricing rules are

[315] Eigelshoven & Limpinsel (2022, [2.2]). The concepts of hidden profit distribution and hidden capital contribution can also apply to cross-border transactions and apply in 'precedence' to Foreign Tax Law (AStG) (Germany) s. 1. The latter provision applies 'when it leads to higher taxation'; Eigelshoven & Limpinsel (2022, [2.1]).

[316] Case C-324/00 *Lankhorst-Hohorst GmbH* v. *Finanzamt Steinfurt* ECLI:EU:C:2002:749 (CJEU). This was, perhaps, an overreaction. Case C-524/04 *Test Claimants in the Thin Cap Group Litigation* ECLI:EU:C:2007:161 (CJEU) suggests that the arm's length test can be applied only to international transactions as a proportionate method of countering tax avoidance. Also, see Case C-311/08 *Société de Gestion Industrielle SA (SGI)* v. *Belgium* ECLI:EU:C:2010:26 (CJEU) and Case C-382/16 *Hornbach-Baumarkt AG* v. *Germany* ECLI:EU:C:2018:366 (CJEU).

[317] Despite their domestic application, the UK transfer pricing rules are contained in TIOPA 2010 (ss. 146–230), a law primarily dealing with international matters.

[318] TIOPA 2010 (UK) s. 147(3).

[319] TIOPA 2010 (UK) s. 164. The OECD is an international organisation of which the UK is a member. In terms of indirect delegation of rulemaking power, the adoption of the Transfer Pricing Guidelines raises an interesting analogy with the use of accounting standards for determination of the corporate tax base.

[320] TIOPA 2010 (UK) s. 166. There are exceptions to the exclusion from the transfer pricing rules for small- and medium-sized enterprises. Medium-sized enterprises may be subject to the transfer pricing rules if served with a notice by the UK tax administration; TIOPA 2010 (UK) s. 168. A more limited notice provision applies to small-sized enterprises; TIOPA 2010 (UK) s. 167A. Small or medium-sized enterprises may be subject to the transfer pricing rules if they are resident in a non-qualifying territory; TIOPA 2010 (UK) s. 167. Qualifying territories are essentially those with double tax treaties with non-discrimination articles; TIOPA 2010 (UK) s. 173.

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couched in terms of a provision between 'persons', but the exceptions refer to 'enterprises', a term more commonly used in civil law jurisdictions. This is because small- and medium-sized enterprises are defined by reference to EU law.[321] The relevant EU law contains thresholds defining these enterprises by reference to number of employees, turnover and net assets. That law contains rules to prevent splitting the thresholds between related enterprises ('partnership' and 'linked' enterprises).[322] Not surprisingly, these anti-splitting rules bear little resemblance to those otherwise used in UK income tax law.

Where the transfer pricing rules apply, they adjust the 'profits and losses of the potentially advantaged person'. 'Profits' and 'losses' are defined to include revenue amounts, but there is no mention of capital amounts.[323] TIOPA 2010 goes on to expressly provide that the transfer pricing rules do not affect the calculation of any capital allowance, balancing charge, chargeable gain or chargeable loss.[324] The result is fragmentation of the transfer pricing approach. This means that the treatment of related party transactions involving many capital assets must be sought in CAA 2001 and TCGA 1992. Both Acts have provisions, but they are very different from those in Part 4 of TIOPA 2010.

CAA 2001 has no general imposition of market value on sales between related parties. A market value rule does apply if plant or machinery is sold at less than market value and the buyer does not hold the acquired asset as plant or machinery.[325] By contrast, TCGA 1992 has a blanket provision treating transfers of assets between 'connected persons' as made at market value.[326] There are important exceptions to this treatment, many of which are discussed throughout this book. These include for transfers between

[321] TIOPA 2010 (UK) s. 172. And this is still true post-Brexit.

[322] European Commission Recommendation 2003/361/EC Annex Arts. 1 to 6.

[323] TIOPA 2010 (UK) s. 156.

[324] TIOPA 2010 (UK) ss. 213 and 214.

[325] CAA 2001 (UK) s. 61(2) and (4)(a). The pooling system for depreciating plant and machinery means there is no other express treatment of below market value sales (such a transaction cannot usually accelerate an allowance). There are special rules designed to prevent sales between 'connected persons' uplifting the qualifying expenditure beyond the original price paid, typically sales above market value; s. 218. Part of the problem is that the connected person disposing of the asset is not required to bring into account as disposal proceeds any more than the original cost of the asset; s. 62. This means any excess is only subject to tax as capital gains. In addition, a person buying plant or machinery from a connected person is denied the annual investment allowance or any first-year allowance with respect to the asset; s. 217.

[326] TGCA 1992 (UK) s. 18 triggering the market value rule in s. 17.

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group corporations (below at 1.2.3.1) and numerous rollovers, especially on incorporation (below at 4.2), corporate reorganisations (below at 7.1) and mergers and demergers (below at 7.2).

There are many differences between these rules in CAA 2001 and TCGA 1992 and the transfer pricing rules in TIOPA 2010. Indeed, it seems the differences between these three sets of rules outweigh their commonality. The CAA 2001 and TCGA 1992 rules are subject to important exceptions, especially for group corporations (discussed below at 1.2.3.1), but the transfer pricing rules are not. There are no exceptions from the CAA 2001 and TCGA 1992 for small- and medium-sized enterprises and the OECD rules are not expressed to be relevant in determining market value. As will be discussed shortly, the concepts of 'control' and 'connected persons' used in these three sets of rules are not the same.[327] Simply, the UK income tax law fails to draw the connection between these rules, providing multiple rules where other countries often provide one unified approach.[328]

1.2.2.2 Relevant Relationship

The US transfer pricing rules speak of 'two or more organizations [etc.] owned or controlled directly or indirectly by the same interests'.[329] The legislation does not elaborate further on the relevant relationship, but the Treasury Regulations do. It is noteworthy that the concept of 'related' persons discussed above at 1.1.5.1 is not used for this purpose. The Regulations supporting the transfer pricing rule contain a series of definitions including definitions of 'organization', 'trade or business', 'controlled' and 'controlled taxpayer'.[330] 'Organisation' covers those entities that could

[327] By contrast, while the loan relationship rules have provisions that apply to non-arm's length transactions, the transfer pricing rules in TIOPA 2010 generally have priority; CTA 2009 (UK) ss. 444 to 446. Similarly, the transfer pricing rules apply to derivatives; s. 693. While the intangible assets regime contains a market value rule similar to that in TCGA 1992, it too gives priority to the transfer pricing rules in TIOPA 2010; CTA 2009 ss. 845 and 846.

[328] Some special rules apply when a person disposes of trading stock on the cessation of a trade. If the sale is to a 'connected person' and that stock constitutes trading stock of the buyer, the sale must be priced at 'arm's length'. This rule applies both for corporation tax and income tax purposes; CTA 2009 (UK) s. 166 and ITTOIA 2005 (UK) s. 177. There are separate definitions of 'connected persons' for this purpose; CTA 2009 (UK) s. 168 and ITTOIA 2005 (UK) s. 179. Confusingly, the TIOPA 2010 transfer pricing rules have priority; CTA 2009 (UK) s. 162(2) and ITTOIA 2005 (UK) s. 173(2). However, it seems that these special rules for trading stock could apply residually if the transaction in question falls within an exception to the TIOPA 2010 rules, for example, a small or medium-sized enterprise is involved.

[329] IRC (US) s. 482.

[330] Title 26 Code of Federal Regulations (US) § 1.482-1(i).

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be within the definition of 'taxpayer' in the IRC (see above at 1.1.1), but it is not necessary to be a US taxpayer. Surprisingly, 'trade or business' includes employment.

The definition of 'controlled taxpayer' does little more than clarify some of the wording used in section 482 of IRC.[331] It repeats the wording of 'owned or controlled directly or indirectly by the same interests' but contains no further elaboration of how to determine indirect control and there is no definition of 'same interests'. The Regulations do clarify that the person owning or controlling the organisations is also a 'controlled taxpayer', which is not clear on the face of section 482.

'Controlled' includes 'any kind of control'. In particular, the control need not be legally enforceable, and control may exist where two persons are acting in concert. It is the reality of control that is decisive, not its form or the mode of its exercise.[332] The definition of 'controlled' is particularly abstract. The US focus seems to be more on the assessment that a transaction is not at arm's length, and so all transactions must be tested if there is a chance that this is not the case.[333] This approach can be contrasted with a more prescriptive definition of the kind of relationship that must exist before a transaction must be tested against the arm's length standard.

China is more prescriptive. The transaction must involve an enterprise and 'its affiliated parties'.[334] A 'party' need not be an 'enterprise'. The Chinese tax administration has defined 'affiliated parties' in terms of one party holding '25% or more of the shares of the other party' or 25 per cent or more of the shares of both parties being held 'by a common third party'. This test appears to apply simply to the number of shares and not their value or the voting rights attaching to them.[335] China goes on to apply alternate tests focusing on 'lending and borrowing' between the parties, business operations of one party being 'dependent' on intellectual property of the other party, business operations 'are controlled by the other party', half the directors or senior management of the corporation may be appointed by the individual or residually simply that both parties have substantial 'common interests'.[336] Consequently, the EITR defines

[331] Title 26 Code of Federal Regulations (US) § 1.482-1(i)(5).
[332] Title 26 Code of Federal Regulations (US) § 1.482-1(i)(4).
[333] For example, see Bittker & Eustice (2003–, para. 13.20) and the references cited therein.
[334] EITL (China) Art. 41.
[335] SAT Announcement [2016] No. 42 Art. 2(1).
[336] SAT Announcement [2016] No. 42 Art. 2(2)-(7).

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'affiliated parties' in terms of 'control over such matters as finance, business operations, purchases and sales, etc.'.[337]

The German international transfer pricing rules (but not the general concepts of hidden profit distribution and hidden capital contribution) similarly incorporate a requirement of 'association'. This is defined broadly to be a 25 per cent 'interest' but is expanded to include the 'exercise of a controlling influence' and even an ability 'to exercise influence' in agreeing the terms of the business relationship for reasons lying outside that relationship.[338]

For purposes of the UK transfer pricing provisions, persons are related if the 'participation condition' is met. This is defined in terms similar to Article 9(1) of the OECD Model referring to one person 'participating in the management control or capital of the other' or the same person or persons doing so.[339] TIOPA 2010 goes on to define 'participating' in very different terms, terms involving a person 'controlling' a 'body corporate or a firm'.[340] Note the reference to 'body corporate' rather than 'company' (see above at 1.1.1.1). Note also that, while these rules can apply to transactions between an individual and a controlled corporation, they cannot apply to transactions between two related individuals.[341] This apparent limitation of scope reflects that in Article 9(1) of the OECD Model.[342]

'Control' was discussed above at 1.1.5.1 and 1.1.5.2 in the context of the definition of 'connected persons' and 'close company', respectively. However, it seems that 'control' as used in the transfer pricing rules does not bear the same meaning.[343] Rather, it takes its meaning from section 1124 of CTA 2010.[344] This provision defines 'control' of a body corporate in terms of a person holding shares, voting power or other powers conferred in the corporation's constitutional documents such that the affairs of the corporation are 'conducted in accordance with the wishes' of the person. This definition would not easily apply to control at the level of the board of directors.

The provisions in CAA 2001 and TCGA 1992 mentioned above are triggered by transactions between 'connected persons'. Each has its own

[337] EITR (China) Art. 109.
[338] Foreign Tax Law (AStG) (Germany) s. 1(2).
[339] TIOPA 2010 (UK) s. 148.
[340] For example, TIOPA 2010 (UK) s. 157.
[341] One consequence of this limitation is the continuing issue of income splitting between related individuals as seen in *Jones* v. *Garnett* [2007] UKHL 35 (HL). See Harris & Oliver (2008).
[342] See Harris (2020, 294).
[343] See text above at footnote 125.
[344] TIOPA 2010 (UK) s. 217(1).

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definition of 'connected persons'.[345] Rather than using 'connected persons' (or 'associated persons') as an aid in defining 'control' (as in the transfer pricing rules and the close company rules), both sets of provisions use 'control' as an aid in defining 'connected persons'. The CAA 2001 and TCGA 1992 rules for connected persons are essentially the same as discussed above at 1.1.5.1 in the context of connected persons under CTA 2010. So, a person is connected with a 'company' (rather than a body corporate) if the person controls the company. Two companies are connected if they are commonly controlled. Both CAA 2001 and TCGA 1992 define 'control' by reference to sections 450 and 451 of CTA 2010 (discussed above at 1.1.5.1 and 1.1.5.2), although CAA 2001 has a supplemental rule.[346]

1.2.2.3 Attribution of Rights

As mentioned above, the US Treasury Regulations repeat the words 'owned or controlled directly or indirectly by the same interests' from section 482 of IRC but contain no further elaboration of how to determine indirect control.[347] So there are no rules on the attribution of rights of related parties. The focus is, rather, on the fact of a non-arm's length price rather than defining a relationship in which an arm's length price must be tested. The wording of the German international transfer pricing rules is similar. They refer to holding 'a direct or indirect interest' and exercising a controlling influence 'directly or indirectly' without any further detail in the law.[348]

Chinese law also refers to 'direct or indirect control', whether by one party over another or by a common third party.[349] However, China does

[345] CAA 2001 (UK) s. 575 and TCGA 1992 (UK) s. 286, respectively.

[346] CAA 2001 (UK) s. 575A and TCGA 1992 (UK) s. 288. The supplemental rule is in CAA 2001 (UK) s. 574. As for the loan relationship rules, they sometimes use the concept of 'connected persons' within the meaning in CTA 2010 (UK) s. 1122 and at other times use a differently defined concept of 'connected companies'; CTA 2009 (UK) s. 466. The latter, like the former, uses the word 'control'. The loan relationship rules sometimes use the concept of 'control' within the meaning in CTA 2010 (UK) s. 1124 and other times use a differently defined concept of 'control'; CTA 2009 s. (UK) 472. By contrast, the intangible assets regime uses a concept of 'related party', again defined in terms of 'control'; CTA 2009 s. (UK) 835. 'Control' is again defined separately; CTA 2009 s. (UK) 836. Like the transfer pricing rules, both the loan relationship rules and the intangible assets regime extend to cover control jointly by two 40 per cent owners. This is done through the concept of 'major interest'; CTA 2009 (UK) ss. 473 and 837, respectively.

[347] Title 26 Code of Federal Regulations (US) § 1.482-1(i)(5).

[348] Foreign Tax Law (AStG) s. 1(2)1.

[349] EITR (China) Art. 109.

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have rules for attributing rights held by one person to another person for the purposes of testing whether two persons are 'affiliated'. For purposes of determining affiliation based on an indirect holding, a party is allocated a proportionate share of shares held 'through an intermediary', but only if the party 'holds 25% or more of the shares of the intermediary'. This is a proportionate approach. However, in determining the holdings of individuals, the holdings of the individual and the individual's relatives are consolidated.[350] This is an absolute approach.

Again, the UK position is anything but straightforward. TIOPA 2010 expressly deals with control by indirect participation. In a manner reminiscent of the similar rules for connected persons and close companies (discussed above at 1.1.5), TIOPA 2010 may attribute certain rights to a person for purposes of determining control, including rights held by 'connected persons'.[351] 'Connected persons' does not take its meaning from section 1122 of CTA 2010 (discussed above at 1.1.5.1) nor from the similarly defined term 'associated persons' in section 448 of that Act (discussed above at 1.1.5.2). Rather, and confusingly, it is defined in extremely similar terms in section 163 of TIOPA 2010. Further, indirect participation may arise where two persons each hold 40 per cent of a corporation.[352]

Despite the bewildering array of prescription, there are fundamental problems in applying the various UK concepts of 'connected person' and 'control', particularly where control of two corporations is wielded by more than one person (the 'group' of persons). One question is whether either corporation is connected with any one person in the group. This depends on whether the holdings of one person in the group may be attributed to another person in the group for purposes of determining the latter's control status. It seems that the transfer pricing rules do not do this because these rules refer to 'one of the affected persons' controlling the company.[353] An exception is where the persons in the group 'act together' in a financing arrangement with one of the corporations.[354] The persons in the group would only be connected with either corporation for capital allowance purposes if two or

[350] SAT Announcement [2016] No. 42 Art. 2(1).
[351] TIOPA 2010 (UK) s. 159.
[352] TIOPA 2010 (UK) s. 160. This provision was added to deal with joint venture companies where neither party may have control.
[353] TIOPA 2010 (UK) s. 148(2)(a) and (3)(a).
[354] TIOPA 2010 s. 161(2). Note that similar phraseology is used in the definition of 'control' in CTA 2010 (UK) s. 450(5) (discussed above at 1.1.5.1).

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more of them are 'acting together to secure or exercise control of the company'.[355] The approach is similar under TCGA 1992.[356]

The situation as to transactions between the two controlled corporations is different. The transfer pricing rules will apply if the two transacting corporations are controlled by 'the same person or persons'.[357] There is no reference here to the persons 'acting together'. By contrast, for two corporations to be connected for the purposes of the capital allowances provisions, both corporations must be 'controlled' by 'a group of two or more persons'.[358] Again, the same test is applied for chargeable gains purposes,[359] and is also used in the definition of 'connected persons' in CTA 2010 (as noted above at 1.1.5.1). Each of these provisions uses the definition of 'control' from section 450 of CTA 2010. Difficulties with this provision were discussed above at 1.1.5.2. In particular, in cases of aggregated control it uses the 'two or more persons together' test. How this test is supposed to interface with the 'group of two or more persons' test is anything but clear.

So, there are three different possibilities under UK law for aggregating control in this scenario: 'persons acting together', 'the same person or persons' and 'a group of two or more persons'. In the first of these cases, it might seem clear that there must be some conscious intention to coordinate action. That argument seems strong in the context of its use in the transfer pricing rules, but in the convoluted mess of the relationship between section 450 of CTA 2010 and the various definitions of 'connected persons' the situation is unclear. In the latter two cases, it is not clear whether the 'persons' need some sort of connection between them for their control power to be aggregated, for example, jointly hold the shares. The Court of Appeal has held that the mere fact the persons are shareholders in both corporations is sufficient.[360] If there is a collection (group) of shareholders that owns the majority of shares of each corporation, then the corporations will be connected.[361]

355 CAA 2001 (UK) s. 575(6).

356 TCGA 1992 (UK) s. 286(7).

357 TIOPA 2010 (UK) s. 148(2)(b) and (3)(b).

358 CAA 2001 (UK) s. 575(5)(d).

359 TCGA 1992 (UK) s. 286(5)(b).

360 Kellogg Brown & Root Holdings (UK) Ltd v. RCC [2010] EWCA Civ 118 (CA).

361 The UK tax administration accepts that two corporations are only under the control of the same persons if the group that controls one corporation is identical with the group that controls the other. In addition, the group must be narrowed so as to be no more than a group that 'would not have control of it if any one of the persons were excluded from the group'. HMRC, *Company Tax Manual* [CTM03730], available at https://bit.ly/45rMg5T, accessed 15 June 2023.

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1.2.2.4 Corresponding Adjustments and Subvention Payments

Transfer pricing adjustments can apply to just one party to a transaction or may automatically apply to both parties to a transaction, that is, they may be one-directional or two-directional. These adjustments are sometimes referred to as primary (increase tax liability) and corresponding (reduce tax liability) adjustments.

In some cases, the rules may be one-directional because the tax administration is provided with a discretion as to whether to make an adjustment. For example, at least in legal form the US transfer pricing rules are discretionary: 'the Secretary may' make an adjustment. However, the regulations permit taxpayers to report transactions 'based upon prices different from those actually charged' in order to 'reflect an arm's length result'.[362] Further, where a primary adjustment is made, the tax administration is required to make 'appropriate' corresponding adjustments.[363]

In China, the legislation is couched in terms of a 'reduction' in income and provides the tax administration a discretion, that is, it 'may, through a reasonable method, make an adjustment'.[364] There is no legislative provision for a corresponding adjustment but the SAT may exercise a discretion to provide one.[365]

In Germany, the rules on hidden profit distributions and hidden capital contributions are not subject to tax administration discretion and in principle apply on a two-directional basis.[366] Adjustments under the Foreign Tax Law are one-directional, they only apply where income has been 'reduced', and there is no legislative requirement for a corresponding adjustment.[367]

The UK market value rule for disposals between connected persons for capital gains purposes operates on a two-directional basis.[368] The seller is treated as receiving market value consideration and the buyer treated as

[362] Title 26 Code of Federal Regulations (US) § 1.482-1(a)(3).
[363] Title 26 Code of Federal Regulations (US) § 1.482-1(g).
[364] EITL (China) Art. 41.
[365] SAT Announcement [2017] No. 6 Art. 29.
[366] For the provider, a hidden profit distribution is not deductible, KStG (Germany) Art. 8(3). For the recipient, recharacterisation of a payment as a hidden profit distribution might trigger dividend relief, for example, the participation exemption in KStG (Germany) Art. 8b. These matters are discussed below at 2.2.2 and 2.4. Further, a hidden capital contribution will be non-deductible for the payer and may reduce the income of the recipient, for example of a subsidiary, due to the fiscal balance sheet approach in EStG (Germany) Art. 4(1).
[367] Foreign Tax Law (AStG) s. 1.
[368] TCGA 1992 (UK) ss. 17 and 18.

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paying market value consideration. The other UK transfer pricing rules are one-directional. The transfer pricing rules in TIOPA 2010 adjust the tax liability of only one party to a transaction, that is, the party that benefits from an 'advantage in relation to UK tax'.[369] Without more, this could produce economic double taxation. Therefore, the disadvantaged taxpayer can make a claim to the tax administration to make a transfer pricing adjustment (a corresponding adjustment).[370] This adjustment is only available if the relevant activities of the disadvantaged taxpayer are within the charge to corporation tax or income tax. The rules in CAA 2001 also operate on a one direction basis; sometimes in the direction of the seller and sometimes the buyer, but there are no rules for corresponding adjustments.

Under the UK transfer pricing rules in TIOPA 2010, it is possible for the parties to an adjusted transaction to make a tax-free payment to each other (often called a 'subvention payment') to bring their cash position into line with the tax result.[371] There is no express provision for subvention payments in the other UK transfer pricing rules (i.e. those in CAA 2001 or TCGA 1992) or in the US, Chinese or German transfer pricing rules. In these cases, perhaps the subvention payment would simply be considered to be part of the transaction in question.

1.2.3 Erosion of Identity: Corporate Groups

This section is concerned with special tax base rules that erode the identity of group corporations. The mechanisms by which erosion may be achieved were considered above at 1.1.4.2. This section considers the operation of those mechanisms in two primary contexts. The first is in the form of deferral of tax consequences when a transaction occurs between group corporations. This typically involves exceptions from transfer pricing rules (discussed above at 1.2.2) under which assets may be transferred between related corporations on a no gain/no loss basis. Second, the erosion may occur in the form of losses incurred by one group corporation reducing profits derived by another group corporation. These two contexts are the focus of this section, but erosions can occur in other contexts.[372] Some of these other areas are considered as a residual matter.

[369] 'Advantage in relation to UK tax' is defined in TIOPA 2010 (UK) s. 155 as smaller profits or greater loss.
[370] TIOPA 2010 (UK) ss. 174 and 188.
[371] TIOPA 2010 (UK) s. 196.
[372] Ting (2012, heading 3.4) identifies 'intra-group loss offset and intra-group asset transfer' as 'the two key functions that a group taxation regime is typically designed to achieve'.

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1.2.3.1 Transaction Deferral

The present discussion is concerned with the deferral of tax consequences resulting from a transaction between two corporations that are members of the same corporate group. This deferral can be achieved in different ways, which often depends on the type of mechanism that has been selected for erosion of the separate identity of group corporations (see above at 1.1.4.2). It may be that the transaction is simply not recognised. Alternatively, the transaction may be recognised, but it may be valued in a way that produces no tax consequences. Another option is that the transaction is recognised and valued at arm's length, but the tax consequences are deferred until some future point. These options are the first matter considered in the present discussion. The discussion then proceeds to consider how a group is defined for purposes of securing deferral.

The focus of the discussion is on special rules that defer the tax consequences of a transaction between group corporations. However, brief consideration needs to be given to the consequences of recognising such transactions, especially where the transaction falls outside the scope of the transfer pricing rules considered above at 1.2.2. Use of the arm's length approach to transfer pricing reinforces the separate tax identity of group corporations. Using any price other than market value as a transfer price between two related corporations enables those corporations to manipulate the comparative size of their tax bases and achieve tax arbitrage. If the income tax law has no express or implicit arm's length pricing rules, then group corporations may engage is such manipulation to the extent permitted by the general law.

The consequences of transfer pricing manipulation between group corporations are usually of two types. First, prices will be manipulated in such a way that unrealised gains will not be realised. So, this can produce similar results as deferral mechanisms. Second, prices will be manipulated in such a way that unrealised losses will be triggered and triggered in the group member most likely to be able to use the loss. This emphasises an important feature of deferral mechanisms; they are designed to prevent artificial loss crystallisation and manipulation just as much as they are to defer the taxation of gains in transactions between group members.

Germany is an example of a country that has no express deferral mechanism for transactions between group corporations. While Germany does not expressly apply transfer pricing rules to domestic transactions between group corporations, the vague concepts of hidden profit

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distribution and hidden capital contribution may produce similar consequences (see above at 1.2.2). But real transactions between members of a corporate group have real tax consequences. Other examples are provided below in the discussion of the manner in which deferral mechanisms operate and limitations on their scope.

Deferral Mechanism As mentioned, there are a number of manners in which a deferral mechanism may operate. One of the features of a pure consolidation regime is that deferral of transactions between group corporations is achieved by ignoring transactions for tax purposes. Group members are considered to be parts of a single corporation for tax purposes (often the parent corporation). As the group is a single person for tax purposes and a person cannot transact with themself, the result is non-recognition. This is the manner in which the Australian consolidation regime operates, see above at 1.1.4.2.[373] The US check-the-box regime, also mentioned at that point, is another example, for example, where a parent corporation wholly owns LLCs as subsidiaries.

Outside a pure consolidation regime, transactions between group members are, in principle, recognised for tax purposes. Because group members are related, transfer pricing rules (see above at 1.2.2) may require that such transactions be valued at an arm's length price. Therefore, in order to produce deferral, a corporate tax system must either override the arm's length pricing requirement or defer the consequences of it. China and the UK provide examples of the override approach and the US provides an example of the deferral approach.

Section 1501 of IRC (US) provides:

> An affiliated group of corporations shall, subject to the provisions of this chapter, have the privilege of making a consolidated return with respect to the income tax imposed by chapter 1 for the taxable year in lieu of separate returns…

This rule is the subject of extensive Treasury Regulations,[374] which confirm that an affiliated group may elect to (but is not obliged to) file a consolidated return.[375] The US's is not a pure consolidation approach, because each member of a corporate group must still calculate their own taxable income independently. In principle, it is only the results

[373] Also, see Ting (2012, heading 7.2).
[374] Title 26 Code of Federal Regulations (US) § 1.1502-0 & following.
[375] Title 26 Code of Federal Regulations (US) § 1.1502-75(a)(1).

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that are consolidated. So, without more information, transactions between members of a corporate group would be recognised (as in Germany) and, potentially, the transfer pricing rules discussed above at 1.2.2 would apply.

The Treasury Regulations confirm that transactions between group corporations are to be quantified on a separate entity basis. So a group corporation selling an asset to another group corporation must recognise gain or loss on the transaction after taking the transfer pricing rules into consideration.[376] However, the timing of the recognition is determined on a single entity basis.[377] This involves the 'matching rule' whereby the selling corporation does not recognise the gain or loss until the buying corporation accounts for the transaction, for example, when the buying corporation sells the asset outside the group.[378] The selling corporation also realises gain or loss when it or the buyer ceases to be part of the group.[379]

Because consolidation is elective, the US regime would be exposed to the crystallisation of losses through transactions between group corporations that are not consolidated. This is addressed by a special rule that provides that losses on sales or exchanges between related parties are generally disallowed.[380] The definition of 'related' for this purpose was considered above at 1.1.5.1. The disallowance is excluded in the case of group corporations (irrespective of whether they file a consolidated return) and replaced with a deferral of the loss until the property is disposed of outside the group.[381] The Treasury Regulations adapt and apply the consolidated return rules for this purpose.[382]

In China, the residual position (noted above at 1.2.2) is that transactions between group members are valued at arm's length prices. An exception involves the transfer of assets between members of a 100 per cent controlled group.[383] Provided certain conditions are met, such a transfer does

[376] Title 26 Code of Federal Regulations (US) § 1.1502-80(a).
[377] Title 26 Code of Federal Regulations (US) § 1.1502-13(a)(2).
[378] Title 26 Code of Federal Regulations (US) § 1.1502-13(c)(2).
[379] Title 26 Code of Federal Regulations (US) § 1.1502-13(d)(1)(i)(A).
[380] IRC (US) s. 267(a)(1).
[381] IRC (US) s. 267(f)(2)(B).
[382] Title 26 Code of Federal Regulations (US) § 1.267(f)-1.
[383] The legal basis of this exception is lengthy. EITL (China) Art. 20 provides a broad delegation of power to the MOF and SAT regarding income and deductions and the 'treatment methods of assets'. EITR (China) Art. 75 require recognition of gains and losses in a 'reorganisation' unless MOF and SAT stipulate otherwise. Circular of MOF & SAT [2009] No. 59 outlines reorganisations and distinguishes between general (recognition) tax treatment

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not give rise to income of the transferor or the transferee, and the transferee takes over the transferor's tax value in the assets. The transaction must have a business purpose and not be for avoiding tax, the business operations with respect to the transferred assets must continue for 12 months and neither the transferor nor the transferee recognises a gain on the transaction for accounting purposes.[384] Further, in the case of a transfer from the parent to a subsidiary, the transfer must be wholly for shares in the subsidiary (see below at 4.1.2.2) or for no consideration. In the case of a transfer from a subsidiary to a parent, the transfer must be for no consideration. In the case of a transfer between two subsidiaries, the transfer must be for no consideration and at the instruction of the parent. In each of these scenarios, there are tax base adjustments to share interests held by the parent in the subsidiaries and the share capital of the subsidiaries may be increased or decreased (for tax purposes).[385]

The approach of the UK must be considered in the context of its fragmented approach to use of the arm's length standard (discussed above at 1.2.2). Where the TIOPA 2010 transfer pricing rules apply, there is no exception for transactions between group corporations. This is a consequence of the perceived need in 2004 to apply these rules on a non-discriminatory basis to both international transactions and domestic transactions. In an international setting, arm's length rules are particularly targeted at group corporations in an effort to prevent moving the source of income outside a tax jurisdiction.

However, where the small or medium-sized enterprise exception to the TIOPA 2010 transfer pricing rules applies, the position in the UK is similar to what it was prior to the domestic introduction of the arm's length rules. There are no other express rules determining the transfer price of particular transactions between related parties for corporation tax base purposes. So, where the TIOPA 2010 rules do not apply, there is substantial freedom to set prices under general law. Provided the transaction is genuine and the consideration not colourable, the prices set as a matter of law by the transaction should be accepted for corporate tax purposes. The same is largely true of the price paid for say plant and machinery for capital allowances purposes. As noted, the TIOPA 2010 transfer pricing rules do not

and special (deferral) tax treatment. Circular of MOF & SAT [2014] No. 109 Art. 3 concerning 100 per cent controlled groups is a specific clarification of reorganisations. This is detailed by further rules in SAT Announcement [2015] No. 40.

[384] Circular of MOF & SAT [2014] No. 109 Art. 3.

[385] SAT Announcement [2015] No. 40 Art. 1.

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apply for the purposes of CAA 2001. Outside the scope of the anti-abuse rules in CAA 2001 (discussed above at 1.2.2), related corporations have a relatively broad scope for negotiating prices on the transfer between them of capital assets for which capital allowances are available.[386]

The position is very different for the purposes of TCGA 1992. As noted, TCGA 1992 has a comprehensive market value rule for transactions between connected persons. However, TCGA 1992 provides an exception to the market value rule for transactions between group corporations. Section 171 provides that where:

> a company ('company A') disposes of an asset to another company ('company B') at a time when both companies are members of the same group … company A and company B are treated for the purposes of corporation tax on chargeable gains as if the asset were acquired by company B for a consideration of such amount as would secure that neither a gain nor a loss would accrue to company A on the disposal.[387]

Note that this provision is non-discretionary. There is no choice as to its application, just as there is no possibility to realise a part gain or loss. Like the US rule discussed above, the UK rule is just as much about preventing corporate groups from crystallising unrealised losses by disposing of assets between group members as it is about providing relief from any charge on a gain realised on such a disposal.[388]

[386] An exception to this rule applies where a trade is transferred as a going concern between members of a corporate group. In this case, CTA 2010 (UK) Part 22 may provide relief from a balancing charge under CAA 2001. This is most commonly used when 'hiving' down a trade to a newly incorporated company, so it is discussed below at 4.2.

[387] Special rules apply where the asset transferred is a capital asset in the hands of one of the group members but trading stock in the hands of the other; see TCGA 1992 (UK) s. 173. The intangible assets regime broadly follows the approach in TCGA 1992 (UK) s. 171 rather than the approach in CAA 2001. Intangible fixed assets may be transferred between group members and treated as not involving any realisation or any acquisition; CTA 2009 (UK) ss. 775 and 776. The tax history of the asset is effectively taken over by the transferee.

[388] Above at 1.2.2, brief mention was made of an arm's length pricing rule for trading stock sold between connected persons if the seller ceases to carry on the trade in question. Where this rule applies, it is possible for corporation tax purposes for the parties to the transaction to elect to, in effect, sell the stock at cost, that is, no gain/no loss basis; CTA 2009 (UK) s. 167. This election is available for a sale between two body corporates if they are subject to common 'control'; CTA 2009 (UK) s. 168. So, this is potentially much broader than the 75 per cent group requirements for other exceptions. This relief is further considered below at in the context of incorporation of a subsidiary. As with the arm's length pricing rule, however, this election is not available if the transfer pricing rules in TIOPA 2010 apply; CTA 2009 (UK) s. 162(2).

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What Is a Group? The concept of group corporations was discussed above at 1.1.5.1 in the context of one corporation controlling another corporation or two corporations being controlled by the same person or persons. However, just because an income tax law has a general concept of group corporations, does not mean that it will use the concept for all purposes. In some cases, a definition of group corporations might be used comprehensively. In other cases, there might be a special or adjusted definition for purposes of a rule deferring the tax consequences of transactions between group members. This is the situation in both the US and the UK. For purposes of the Chinese deferral rule, group corporations are identified as discussed above at 1.1.5.1.

As mentioned above, section 1501 of IRC (US) permits an 'affiliated group of corporations' to file a consolidated tax return. This is done by election, which is in principle irrevocable.[389] 'Affiliated group' is defined in section 1504(a)(1) in terms similar to, but not the same as, 'controlled group of corporations' discussed above at 1.1.5.1. An 'affiliated group' is 'one or more chains of includible corporations connected through stock ownership with a common parent corporation which is an includible corporation'. The 'includible corporation' concept is used to prevent certain types of corporations from being within a group that files a consolidated return. So, for example, tax-exempt corporations, foreign corporations and S corporations are not includible corporations, although there are exceptions to the exceptions.[390]

To be included in an affiliated group, there are two tests of 'stock ownership' that count. First, the parent corporation must own directly at least 80 per cent of the total voting power and total stock value of at least one includible corporation.[391] From this point and under the second test, further corporations must be owned directly as to a similar 80 per cent by other corporations included in the group. So, working down from the parent corporation at the head of a group chain, as each corporation is included because it meets the 80 per cent test, its holdings in another corporation may be counted in determining whether the other corporation also meets the 80 per cent test. However, the requirement of a common parent corporation means that two sibling corporations owned by,

[389] Title 26 Code of Federal Regulations (US) § 1.1502-75(a)(2).

[390] IRC (US) s. 1504(b).

[391] 'Stock' excludes certain non-voting preference shares; IRC (US) s. 1504(a)(4). Voting power focuses on the right to elect directors. See Bittker & Eustice (2003–, para. 13.41) and the references cited therein.

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for example, an individual cannot file a consolidated return. Only direct holdings are counted and there are no constructive ownership or other attribution of rights rules.

The UK also refines its concept of group corporations depending on the rule in question. For the purposes of the non-recognition rule for capital gains, 'group companies' is defined in section 170(3) of TCGA 1992 by reference to a 'principal company' and its '75% subsidiaries'. '75% subsidiary' is defined by reference to section 1154 of CTA 2010, which was discussed above at 1.1.5.1. TCGA 1992 is peculiarly prescriptive in identifying the types of companies that can be group companies.[392] It is now possible for a non-resident company to qualify as the principal company or a subsidiary, but section 171 applies only to transactions involving a non-resident company if a UK PE of the non-resident company buys or sells the asset in question.[393]

It will be recalled that under the definition of '75% subsidiary', a parent corporation can satisfy the 75 per cent holding requirement by holding shares directly or indirectly. However, 'group companies' for the purposes of TCGA 1992 is given an extended meaning. If A Co holds 75 per cent of B Co, which holds 75 per cent of C Co, C Co is not a 75 per cent subsidiary of A Co. This is because A Co's indirect holding in C Co is only 56.25 per cent, that is, 75 per cent of 75 per cent. 'Group companies' in TCGA 1992 specifically includes 75 per cent subsidiaries of 75 per cent subsidiaries. However, the UK rule contains an additional limitation; each subsidiary

[392] Some entities that fall within the definition of 'company' (see above at 1.1.1.1) cannot be group companies. The types of companies that can be are listed in TCGA 1992 (UK) s. 170(9). Bizarrely, this list does not refer to 'body corporate', although clearly most of the entities referred to are corporations. This is even more bizarre because, as discussed above at 1.1.5.1, CTA 2010 defines '75% subsidiary' in terms of a 'body corporate' holding 75 per cent of the ordinary shares in another 'body corporate'. If an entity is not a body corporate, it is difficult to see how this definition could apply. A further difficulty is that some of the entities referred to in the TCGA 1992 list might not have a share capital.

[393] A non-resident company can hold shares so as to cause other companies to qualify. So, for example, TCGA 1992 (UK) s. 171 can apply to two UK-resident companies that are 75 per cent subsidiaries of a non-resident company. To facilitate this extension, s. 170(9) provides that 'company' includes a 'company … formed under' foreign law. It is not clear whether 'company' here takes its meaning from the general definition in s. 288, has its ordinary meaning (which could include, for example, a partnership) or only refers to registered companies. In any case, because of the definition of '75% subsidiary', it seems a foreign company would have to be a body corporate and have a share capital. The requirement that a foreign company must be incorporated is confirmed by s. 170(2)(d). This provision prescribes that 'group' and 'subsidiary' be 'construed with any necessary modifications where applied to a company incorporated under' foreign law. Again, the clarity of UK tax law leaves something to be desired.

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must be at least an effective 51 per cent subsidiary of the principal company. Section 170(7) of TCGA 1992 contains a definition of 'effective 51 per cent subsidiary'. Essentially, the principal corporation of the group must be beneficially entitled to 51 per cent of distributions of profits from the subsidiary or assets in a winding up. In a standard situation, C Co in the example will meet this test.

Tax laws that provide a definition of group corporations with less than a 100 per cent holding requirement often have rules to stop corporations acting as bridges between two groups. To demonstrate the problem, consider the example in the last paragraph. In addition, presume that C Co holds 75 per cent of D Co. Indirectly, A Co holds only 42 per cent of D Co (approximately) and so D Co is not an effective 51 per cent subsidiary of A Co. However, there could be two corporate groups on these facts; the first made up of corporations A, B and C and the second made up of corporations B, C and D. Using section 171 of TCGA 1992, A Co could transfer an asset on a no gain/no loss basis to B Co or C Co based on the first group. Then the acquiring company could transfer the asset on the same basis to D Co based on the second group. If bridge companies were permitted, the tax deferral could go on ad infinitum. For this purpose, section 170(6) provides that a corporation cannot be a member of two groups and provides a series of reconciliation rules for deciding which group a corporation belongs to.

It seems this issue does not arise under the US consolidation regime. On the facts in the last paragraph, if each of the holdings were increased to 80 per cent, then all of A Co, B Co, C Co and D Co would have to combine as a group if they wished to file a consolidated return. This is because the US simply counts direct holdings of includible corporations and, unlike the UK, does not have an indirect holding requirement of the parent corporation in each subsidiary.

1.2.3.2 Loss Relief

The separate tax identity of related corporations may be eroded when calculating their tax bases by permitting a loss incurred by one corporation to reduce the profits derived by another corporation in the same corporate group. Transaction deferral, considered under the last paragraph, has the propensity to transfer tax attributes between corporations as a result of a transaction. By contrast, loss offset transfers tax attributes between group corporations irrespective of actual transactions between the corporations.

Tax attributes are features of a tax system that attach to tax subjects and which are carried forward from one tax period to another. Losses

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are tax attributes because typically they can be used in different manners in the tax period in which they are incurred or carried forward or backward to other tax periods.[394] Therefore, in order to understand how losses may be used in the context of a corporate group, it is necessary to understand how losses may be used by a single independent corporation. That was discussed above at 1.2.1. This paragraph progresses that discussion by first considering the various mechanisms by which a loss of one corporation may be set against the profits of another corporation in the same corporate group.

Group loss relief mechanisms share a number of issues. One is what constitutes a corporate group for the purposes of the loss relief mechanism. Another issue involves the limited liability that usually protects one group member from another group member's losses. A fundamental question is why one group member (including a parent corporation) should benefit from another group member's losses for tax purposes if the first group member is not commercially liable for those losses. Most group loss relief mechanisms do not require a connection between tax and commercial reality. However, some group systems do require a group member to be personally liable for the loss of another group member in order to benefit from the loss for tax purposes. This is typically a feature of group contribution regimes. It is also a feature of the German *Organschaft* regime discussed below. It is not a feature of group loss relief in the UK or the US.

Relief Mechanism There are various mechanisms by which a loss of one corporation may be set against the profits of another corporation in the same corporate group. The set-off may be achieved by directly attacking the identity of group corporations in whole or in part, that is, pure or partial consolidation. Alternatively, the separate identity of corporate group members may be respected in form, but indirectly attacked through the transfer of tax losses between group members. There are two primary methods by which this can be achieved. The transfer may be available irrespective of any transaction between the group corporations. Alternatively, the loss transfer may be made indirectly by requiring a group corporation with profits to make a financial contribution to the group corporation with losses, that is, make a payment to the loss corporation. The manner in which each of these mechanisms operates will also depend on the general rules for use of losses of an independent corporation (discussed above at 1.2.1).

[394] See above at footnote 97.

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The following discussion draws on examples of group loss relief mechanisms of a number of countries. As a preliminary matter, China's income tax law incorporates no mechanism for group relief of losses.

Pure Consolidation In a pure consolidation regime, there are no independent tax bases for individual group corporations, there is only the single tax base of the corporate group as a whole. As a result, a corporate tax system adopting pure consolidation simply applies the loss rules for an independent corporation to corporate groups, that is, there is no need for special group loss relief rules. This is the situation under the Australian pure consolidation regime and under the US check-the-box regime with respect to disregarded entities (see above at 1.1.4.2). No doubt, there is an aspect of simplicity to this approach, at least for stable corporate groups. That simplicity is dramatically offset by complications caused for pure consolidation regimes when corporations join or leave a corporate group. These issues are considered below at 5.2.

Partial Consolidation Instead of pure consolidation, a corporate tax system might collapse the separate identity of corporations only for certain purposes. The US consolidated return regime is an example of this approach. As noted above at 1.2.3.1, the Treasury Regulations specifically state that group corporations are 'treated as separate entities for some purposes but as divisions of a single corporation for other purposes.'[395] Group corporations are treated as separate entities for purposes of calculating income but are treated as a single corporation for purposes of timing recognition of intra-group transactions.

Group corporations are also treated as a single corporation when it comes to filing tax returns. For the purposes of a consolidated return, 'consolidated taxable income' is determined, amongst other things, by 'taking into account … [t]he separate taxable income of each member of the group…'[396] The 'separate taxable income' of a group member is computed in the usual way (subject to modifications) and includes 'a case in which deductions exceed gross income', that is, includes a loss.[397] The result is that losses of one group member offset the taxable income of another group member in arriving at consolidated taxable income.

[395] Title 26 Code of Federal Regulations (US) § 1.1502-13(a)(2).
[396] Title 26 Code of Federal Regulations (US) § 1.1502-11(a)(1).
[397] Title 26 Code of Federal Regulations (US) § 1.1502-12.

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By contrast, a 'consolidated capital gain or loss' is determined by reference to the 'aggregate gains and losses of members from sales or exchanges of capital assets for the year'. So, the netting of individual gains and losses occurs at the consolidated level, not the level of individual group members.[398]

Loss Transfer A corporate tax system that adopts a consolidation approach to corporate groups ensures that profits and losses of all group members are offset to produce a final single taxable income for the group as a whole. By contrast, a corporate tax system that recognises for tax purposes the individual identities of each group member runs the risk that losses will be stranded in some group members while other group members might be paying tax on profits. Especially for corporate groups, which act as a single economic unit, the taxation of one part of the unit while the other part of the unit suffers a loss may seem harsh and anti-intuitive. It will also give the group an incentive to rearrange its affairs so as to ensure that losses are not stranded.

Adjusting transfer prices may, to the extent accepted for tax purposes, enable a corporate group to manipulate the profits and losses of individual group members so as to ensure that losses are not stranded. Specific tax law erosions of corporate identity that prescribe a no gain/no loss treatment of transactions between related corporations may achieve the same result, although they may also prevent the early recognition of losses, as in China and the UK rule for transfers of capital assets between group members (discussed above at 1.2.3.1). Such treatment, in effect, enables the transfer of gains and losses between group members. Transfer of gains and losses between related corporations based on transactions between them is 'self-help' group relief.

A corporate tax system that recognises the separate identity of each member of a corporate group may, however, expressly permit the transfer of losses from one member to another. It is also possible to permit the transfer of profits, as this may achieve the same result. The important point for present purposes is that the individual profits and losses of each member of a group have been determined, that is, all transactions between group members have been priced and accounted for (if necessary) in calculating those profits and losses. The transfer of profits or losses is commonly referred to as 'group relief'.

There are various ways in which group relief may be structured. It may involve the simple transfer of losses, as in the UK (discussed below). In

[398] Title 26 Code of Federal Regulations (US) § 1.1502-22(a).

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such a case, there is an issue as to whether there is any restriction on the direction in which the loss may be transferred, for example, from subsidiary to parent, from parent to subsidiary or from subsidiary to subsidiary. Usually, there is no such restriction. Such a case will also involve the issue of whether payment should be made for such a transfer. Some countries, like the UK, leave this to be determined according to corporate law, but ignore the effects of any payment for tax purposes.

It is also possible for the results of individual group members to be transferred in one direction, typically up to the parent of the group. So, the losses of one subsidiary and the profits of another subsidiary might be offset against each other, but they would do so by reason of each being transferred to the parent. Germany has a form of group relief involving the transfer of independent tax results of group corporations to the parent corporation, referred to as the *Organschaft* regime.[399]

Section 14 of the KStG provides that if a resident corporation enters into an agreement to transfer profits (*Beherrschungsvertrag*) as referred to in section 291(1) of the AktG, in which it must transfer its entire profits to another domestic commercial enterprise, 'then the income of the subsidiary shall be attributed to the primary enterprise (controlling entity)'. There are certain corporate law requirements with respect to such an agreement, and there are additional tax law requirements. The agreement must be registered with the Trade Register. It must be concluded for a minimum of five years.[400]

The profit-sharing agreement is a legally binding agreement that requires the approval of 75 per cent of the capital represented at a members meeting of the subsidiary.[401] Under the agreement the subsidiary must transfer all its profits to the parent. The agreement will also require the parent to pay for losses of the subsidiary. An actual 'money transfer' has to take place (in very broad terms with exceptions). The transfer of profits and losses occurs not only for tax purposes but is also reflected in the financial accounts. The parent shows the subsidiary's profits and losses in its own financial accounts. Subsidiaries still separately file tax returns, but their income is shown as transferred to the parent. The income of subsidiaries is thus reduced to zero if the parent holds 100 per cent of the shares. Minority shareholders are discussed further below.

[399] Generally, see Weiss (2019).
[400] KStG (Germany) s. 14(1)3.
[401] AktG (Germany) s. 293.

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The *Organschaft* regime is the only possibility in the German corporate tax system for group loss relief. Its holistic approach can be contrasted with the fragmented UK approach, which typically involves the transfer of losses. Under section 99 of CTA 2010 a corporation may surrender trading losses of an accounting period. This, of course, only deals with one aspect of the schedular system, but the provision extends to cover other aspects including excess capital allowances, deficits on loan relationships, losses of a UK property business, management expenses of an investment company and non-trading losses on intangible fixed assets. In the case of trading losses and deficits on loan relationships, a corporation can surrender the loss or deficit even if it has other income that it could use the loss against, for example, foreign income for which a foreign tax credit is available.[402] Otherwise, amounts can be surrendered only if the surrendering corporation cannot use them.[403] The following discussion focuses on trading losses.

There are various restrictions on the type of corporation that may surrender a trading loss. The broadest category that can is resident corporations.[404] It is also possible for a non-resident corporation to surrender a trading loss. This may happen where the corporation conducts a trade through a PE situated in the UK, and so is subject to corporation tax with respect thereto.[405] There are also special restrictions for dual resident corporations.[406]

The UK legislation is more prescriptive when it comes to who can claim a loss that is surrendered. Broadly, a corporation (the 'claimant corporation') may make a claim for group relief for an accounting period in relation to a surrendered loss where the following conditions are met:

* The surrendering corporation must consent to the claim.
* The accounting period of the claimant corporation with respect to which the claim is made must overlap with the accounting period of the surrendering corporation in which the loss was incurred.
* At a time during the overlapping period, the group condition is met.[407]

402 CTA 2010 (UK) s. 99(3).
403 CTA 2010 (UK) s. 105.
404 CTA 2010 (UK) s. 106. A loss cannot be surrendered if it was incurred by a foreign PE of a resident company and that loss can be used by another person under a foreign tax law, for example under a group relief system of the country in which the PE is situated.
405 CTA 2010 (UK) s. 107. Again, there is a requirement that the UK loss not be relievable in a foreign country.
406 CTA 2010 (UK) s. 109.
407 CTA 2010 (UK) s. 130.

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Where a qualifying claim is made, 'group relief is given by the making of a deduction from the claimant company's total profits of the claim period'.[408] If the accounting periods of the claimant corporation and the surrendering corporation do not coincide, then relief is granted to the extent of the overlap. This is usually done on a time apportionment basis.[409]

Historically, group relief was only available on a current year basis. A corporation could only surrender a loss of the current year and a claimant corporation could only claim the loss to the extent of its corresponding current year. This limit was removed from 2017, at the same time as the introduction of the 50 per cent limitation on the use of carried forward losses against current year profits. It is now possible for a group member to surrender carried forward losses to another group member.[410] However, from 2017 use of surrendered carried forward losses is subject to the 50 per cent limitation in the hands of the claimant company.[411] Group relief is not available with respect to the carry back of losses.

The UK group relief system does not apply to capital losses and historically it was not possible to transfer capital losses between members of a corporate group. However, it is possible to achieve a similar treatment to transfer of a loss by transferring a capital asset with a latent gain to the group member with a capital loss using section 171 of TCGA 1992 (discussed above at 1.2.3.1). That group member then sells the capital asset outside the group, realises the gain and sets the capital loss against it. This route requires an actual transaction and that can involve substantial transaction costs, in particular the possibility of a stamp duty charge. Relief from the need to transfer the asset with the latent gain was provided in 2000 and liberalised further in 2009.

The relief is provided by section 171A of TCGA 1992. It applies where a member of a corporate group makes a capital gain or loss with respect to an asset. If at that time the company could transfer the asset to another member of the group using section 171, the capital gain or loss may be transferred to the other group member. Both members must elect for the transfer. It is possible to transfer only part of a gain or loss and multiple elections may be made with respect to the same gain or loss (not exceeding in total the gain or loss). So, for example, a capital loss may be split between a number of group members.

[408] CTA 2010 (UK) s. 137(1).
[409] CTA 2010 (UK) ss. 139, 140 and 142.
[410] CTA 2010 (UK) ss. 188BB, 188CB and 188CK.
[411] CTA 2010 (UK) s. 269ZD(3)(j).

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While conceptually there is now common ground between section 171A and the transfer of losses under group relief, the methods by which the transfer is achieved are very different, and there is no possibility to transfer profits under group relief. The lack of consistency is underlined by the intangible assets regime. As noted above at 1.2.3.1, it has a provision broadly consistent with section 171 of TCGA 1992. However, it has no equivalent to section 171A. Rather, it seems that if there is a loss on a fixed intangible asset used in a trade that loss will flow into the calculation of income profits of the trade.[412] If it produces a loss for the trade, group relief will be available. So, section 171A is really a function of the quarantining of capital losses.

Group Contribution By contrast, under a group contribution regime, the losses/profits are transferred by the very mechanism of a payment. Under this sort of relief, a group member makes a payment to the loss-making company. That payment constitutes income of the loss-making company (thus reducing its loss) and is deductible to the paying company, which thereby gets use of the loss. As this sort of system requires an actual payment, it can be difficult to determine whether such a payment has, in substance, been made. Again, it is usual that the payments can be made in any direction within a corporate group. This sort of system is used in Finland, Norway, Sweden and, from 2019, Belgium. The UK used such a system from 1953 to 1967 for income and corporation tax purposes.[413]

To use the Swedish regime as an example, section 1 of Chapter 35 of the Income Tax Law (*Inkomstskattelagen*) provides: 'Group contributions will be deducted by the giver and be entered by the recipient if the conditions for deductions in this Chapter have been fulfilled'. The chapter goes on to define 'parent corporation' in terms of a 90 per cent holding. Contributions may be made between a parent corporation and its subsidiaries and between subsidiaries.[414] The similar systems in Finland and Norway were in issue in two important cases before the Court of Justice of the European Union (CJEU) and the Court of the European Free Trade Association, respectively.[415]

[412] It is also possible to obtain group relief for a non-trading loss on intangible fixed assets; CTA 2010 (UK) s. 99(1)(g).

[413] See Harris (2011, 203 and 205).

[414] Income Tax Law (*Inkomstskattelagen*) (Sweden) Chapter 35 ss. 3 and 4.

[415] Case C-231/05 *Oy AA* ECLI:EU:C:2007:439 (CJEU) (Finland) and Case E-7/07 *Seabrokers AS* v. *Staten v/Skattedirektoratet* (2008) 10 ITLR 805 (EFTAC) (Norway). Finland has a

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What Is a Group? General issues pertaining to the identification of group corporations were discussed above at 1.1.5.1. The current discussion is concerned with any special definition or adaptations of a general definition that are used for purposes of group loss relief. As an initial point, there is no obvious reason why the identification of group corporations for this purpose should be the same as that used for identifying the relationship to which arm's length transfer pricing rules apply (discussed above at 1.2.2). The rules under present discussion are concerned with the erosion of the separate identity of corporations whereas the transfer pricing rules are concerned with reinforcing that identity. And that is the general practice of countries, that is to say, that the rules for identifying the subjects of the respective rules are not the same.

A second issue is whether the rules for identification of group corporations are the same for group transaction deferral as they are for group loss relief. In the case of the US they are, because transaction deferral and loss relief are parts of a single group system, that is, groups for loss relief purposes are identified in the same manner as for transaction deferral (see above at 1.2.3.1). The situation is different in Germany and the UK.

Germany has no rules for group transaction deferral, but it has rules for group loss relief. The tax rules for identifying who may benefit from profit and loss transfers under the German regime were discussed above at 1.1.5.1. It will be recalled that for tax purposes, it is sufficient that a person holds a 'participation in the controlled company … such that the majority of the voting rights of the shares in the subsidiary are held' by the controller.[416] Two features of this test are striking when compared to the other systems. First, it is solely based on voting power and, second, it is sufficient to hold just in excess of 50 per cent of such power. This compares with the 80 per cent test in the US and the 75 per cent test in the UK. However, this German level is slightly misleading because, as noted above, the members of the controlled corporation must pass a 75 per cent resolution under corporate law in order to conclude the profit-sharing agreement that triggers the group loss relief regime.

Another peculiar feature of the German system when compared to the other systems is that the controller (person to whom the profit or loss

separate Group Contributions Law (*Laki konserniavustuksesta verotuksessa*) (Finland). The Norwegian group contribution regime is in Income and Capital Tax Law (*Lov om skatt av formue og inntekt*) (Norway) Arts. 10-2 to 10-4.

[416] KStG (Germany) s. 14(1)1.

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is transferred) is effectively identified as a business. This means that the 'parent' of a corporate group can be an individual conducting a business, a partnership or even a German PE of a non-resident. In the UK and the US, the parent must be a corporation. As discussed above at 1.1.5.1, for the purposes of determining whether a majority of voting rights is met for German tax purposes, a person may be attributed voting rights held by a corporation in which that person holds a majority of voting rights. The law is not express, but it seems this is a proportionate approach.

Again, the UK approach is fragmented and requires some explanation. The rules for group identification for purposes of deferring the tax treatment of disposal of capital assets (above at 1.2.3.1) are the same as those for transferring capital gains and losses between group members. By contrast, the rules for group identification for purposes of transferring revenue losses of a trade are different. Revenue losses of a trade may only be surrendered to and claimed by corporations that are members of the same 'group of companies'. Two corporations are members of the same group of companies if one is a '75% subsidiary' of the other or both are '75% subsidiaries' of a third company.[417]

The definition of '75% subsidiary' in section 1154 of CTA 2010, discussed above at 1.1.5.1, is used for the purposes of group relief.[418] As noted at that point, the definition is limiting because the definition of '75% subsidiary' requires both the parent and the subsidiary be 'body corporates' and that they have an ordinary share capital. While the group relief provisions refer to 'company', the general definition of 'company' (discussed above at 1.1.1.1) does not apply and 'company' is restricted to 'body corporates'.[419] The requirement of ordinary share capital is relaxed for certain registered societies so as to treat their capital as though it were ordinary share capital.[420]

Another requirement discussed above at 1.1.5.1 is the requirement that the ordinary share capital in the subsidiary be owned beneficially by the parent corporation. As mentioned at that point, the courts have interpreted the concept of 'beneficial ownership' quite formally and left substantial scope for manipulation of which corporations are within a corporate group. This is particularly the case considering that there is no requirement that the parent hold the shares in the subsidiary for any

[417] CTA 2010 (UK) s. 152.
[418] CTA 2010 (UK) s. 151(1).
[419] CTA 2010 (UK) s. 188(1).
[420] CTA 2010 (UK) s. 151(2).

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particular period of time. As a result of these limitations, the concept of 75 per cent subsidiary is narrowed for the purposes of the group relief rules in a number of respects.

First, shares held as trading stock do not count towards the 75 per cent threshold.[421] Second, two corporations are not treated as members of the same group if there are certain arrangements in place. These are to transfer one of the corporations out of the group or under which a third party could obtain control of only one of the corporations or under which the trade of one of them could be carried on by a third party.[422]

More substantially, a 75 per cent subsidiary does not qualify unless the parent corporation is 'beneficially entitled' to 75 per cent of profits of the subsidiary available for distribution to 'equity holders' and would be so entitled to 75 per cent of assets available for distribution on a winding up.[423] 'Equity holder' is defined in section 158 of CTA 2010 in terms of the holder of ordinary shares or the holder of a loan that is not a 'normal commercial loan'. Both phrases, 'ordinary shares' and 'normal commercial loan', are further defined. The former is defined to exclude certain fixed-rate preference shares, but the types of preferences shares excluded are substantially more prescriptive than the definition of 'ordinary share capital' used for the purposes of the definition of '75% subsidiary' (discussed above at 1.1.5.1).[424] A loan creditor will constitute an equity holder where the return on the loan is dependent on the results of the corporation's business or its assets.[425]

Section 165 of CTA 2010 defines beneficial entitlement to profits and similarly section 166 deals with entitlements on winding up. Considering the flexibility of corporate financing, defining such entitlements as a percentage at any point in time is difficult. Depending how they are structured, rights to corporate profits may change in entitlements depending on future events. Accordingly, CTA 2010 continues to prescribe rules for determining the entitlement of shares with limited or temporary rights and shares affected by options.[426]

In the result, the definition of group for the purposes of group relief is substantially different from that for transferring capital assets on a no

[421] CTA 2010 (UK) s. 151(3).
[422] CTA 2010 (UK) s. 154.
[423] CTA 2010 (UK) s. 151(4).
[424] CTA 2010 (UK) s. 160. To qualify for group relief a parent company's holding must qualify as both 'ordinary share capital' and 'ordinary shares'.
[425] CTA 2010 (UK) s. 162.
[426] CTA 2010 (UK) ss. 170 to 172 and 173 and 174, respectively.

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gain/no loss basis discussed above at 1.2.3.1, that is, under section 171 of TCGA 1992. Under TCGA 1992, a group includes a parent corporation as well as 75 per cent subsidiaries of the parent's 75 per cent subsidiaries and 75 per cent subsidiaries of 75 per cent subsidiaries. There is a requirement that any subsidiary is an effective 51 per cent subsidiary of the parent corporation, but this is dramatically different from the equivalent 75 per cent rule for group relief. The 51 per cent subsidiary is, like the corresponding rule in group relief, defined by reference to distributions of profits or assets in a winding up and the TCGA 1992 definition borrows the concepts of 'beneficial entitlement' and 'equity holder' for this purpose from the group relief provisions.[427]

There are other differences between groups under group relief and under TCGA 1992. In the latter, there is no exclusion for counting shares held as trading stock. There is no exclusion for corporations subject to arrangements for transfer out of the group etc. This may be tempered in the TCGA 1992 context by the rules that reconcile to which group a corporation belongs. There is no provision in the group relief rules stating that a corporation cannot simultaneously be a member of two or more groups. Perhaps it doesn't need such a rule, but the contrast between these similar provisions is confusing. Another difference is that group relief is limited to body corporates whereas the TCGA 1992 rules are more prescriptive.

Why the UK rules on group transaction deferral and group loss relief use different concepts of 'group' is not clear, although no doubt it has to do with the differing historical origins of the provisions. The bizarre result is that a corporation may in effect transfer capital gains and losses to another corporation in circumstances where it could not transfer trading losses, at least not without transferring the trade. This is despite the fact that capital gains and profits of the trade both fall within total profits that are subject to corporation tax. This is just another area in which the UK corporate tax system is a mess.

Minority Shareholders As noted above at 1.1.4.2, minority owners cause particular problems for corporate tax systems that erode the separate identity of corporations. These problems arise in various contexts, including group transaction deferral, but it is useful to consider some practical examples in the context of group loss relief, where the issues are illuminating. Each of the group loss relief regimes of Germany, the UK

[427] TCGA 1992 (UK) s. 170(8).

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and the US may apply in the context of minority shareholders. In other countries, the potential for minority shareholders is often reduced (or eliminated) through high holding requirements (e.g. under the Chinese book value asset transfer regime and the Australian consolidation regime, which in principle require subsidiaries to be wholly owned).

Each of the German, UK and US group loss relief regimes adopt the attribution only to controllers approach. That is, these regimes have the potential to allow, for example, a parent corporation to claim 100 per cent of a subsidiary's loss even if the parent holds less than 100 per cent of the shares. Issues with respect to this approach were discussed above at 1.1.4.2. Some group loss relief regimes engage, either directly or indirectly, with these issues, whereas others are silent and leave them to corporate law. For example, the US consolidated return regime is silent on the matter.[428]

UK tax law is similarly silent as to the treatment of minority shareholders, although the issues are indirectly acknowledged in the treatment of subvention payments. Losses may be transferred irrespective of subvention payments. Nevertheless, it is common for group members receiving the benefits of a loss transfer to pay for this benefit.[429] Indeed, there is a question as to whether the directors of the surrendering company are required by corporate law to demand such a payment. In any case, any such payment is expressly not income of the recipient and not deductible to the payer.[430] There is a similar provision in the context of group transaction deferral.[431] The payment that is not recognised can be anything from nothing up to the amount of loss, although it is typically no more than the tax value of the loss (loss multiplied by the corporate tax rate). Subvention payments (or lack thereof) provide broad scope for shifting value between group members, a matter discussed below at 8.2.2.

In contrast to group loss relief regimes that have no requirement for payment of losses, by design the Scandinavian group contribution regimes require full payment. At some level, this overcompensates minority shareholders. What the minority shareholders lose through group loss relief is the tax value of the loss of their corporation (loss

[428] See Bittker & Eustice (2003–, para. 13.41), which notes that '[p]rivate law problems can be created by an election to file a consolidated return. For example, filing may be beneficial to the group as a whole at the expense of the minority shareholders of one of the included subsidiaries.'

[429] Regarding subvention payments in the US, see Sparagna (2004, 717).

[430] CTA 2010 (UK) s. 183.

[431] TCGA 1992 (UK) s. 171(6).

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multiplied by the corporate tax rate). This is the maximum value of the availability of the loss for the corporation in the future. Instead, minority shareholders indirectly benefit from the face value of the loss, something they could never do in the absence of group loss relief. This may well be an appropriate policy to support minority shareholders, but it is not neutral from a tax perspective.

These positions can be contrasted with the tax law and corporate law requirements of the German *Organschaft* regime. Where a profit-sharing agreement is in place and there are minority shareholders, the minority shareholders of the subsidiary must receive a 'reasonable compensation'.[432] The compensation can be a fixed periodic payment or it can be dependent on the profit of the parent (but it must be independent of the profit of the subsidiary). The payment may be from the parent or the subsidiary. The tax law then provides that these compensation payments (grossed up by the corporate tax rate) constitute the taxable income of the subsidiary.[433] The subsidiary is liable to pay corporation tax on this amount of income, irrespective of whether the compensation payment is made by the subsidiary or the parent.[434]

1.2.3.3 Other Areas

There are other areas where the separate identity of group corporations may be eroded in calculating their respective taxable incomes. Two examples will suffice. This erosion can occur where there is some threshold for obtaining a relief. So, for example, in the US a 'controlled group' must split the limitation on first-year expensing allowance between members as if they were 'one taxpayer'.[435] 'Controlled group' is defined by reference to section 1563(a) of IRC (discussed above at 1.1.5.1), except that the 80 per cent test is replaced with a 50 per test.[436]

Similarly, in the UK, group corporations are entitled to only one annual investment allowance for capital allowance purposes. For this purpose, group is identified by reference to the Companies Act rather than any other definition in the Corporation Taxes Acts.[437] There are other rules

[432] AktG (Germany) s. 304. Section 305 goes on to require the parent to offer all outstanding shareholders redemption of their shares, either for cash compensation or for shares in the parent.
[433] KStG (Germany) s. 16.
[434] Generally, see Weiss (2019, 424).
[435] IRC (US) s. 179(d)(6).
[436] IRC (US) s. 179(d)(7).
[437] CAA 2001 (UK) s. 51C.

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for related companies and related groups controlled by non-corporates. In particular, there is only one allowance for two companies controlled by the same individual.[438] However, it seems that an individual and a company controlled by the individual each get an annual investment allowance. In the usual way, the definition of control is fragmented.[439]

These allowance restrictions are examples of an unfavourable erosion of the corporate identity, but there are examples of favourable ones. This happens when a corporation is permitted to use some allowance granted to another related corporation. The UK's section 175 of TCGA 1992 provides an example of this approach. Section 152 permits a person that realises a gain on the disposal of an asset used in a trade to 'rollover' (defer) taxation of that gain. In effect, this is achieved by reducing the cost base of an asset acquired as a replacement for the disposed asset by the amount of the gain. Section 175 extends the rollover to the situation in which one member of a corporate group disposes of an asset and the replacement asset is acquired by another member of the group.

1.2.4 Erosion of Identity: Other Related Corporations

Section 1.2.3 focused on the erosion of separate corporate identity in the context of corporate groups. Such erosion can also occur in other related corporation scenarios identified above at 1.1.5. So, for example, it may occur where an individual controls a corporation (1.1.5.1) or where a corporation is closely held by a group of persons (1.1.5.2). Tax laws sometimes deal with these matters, but it is less common than group relief. A few examples pertaining to the calculation of the tax base will suffice, but others are discussed in the remainder of this book.

1.2.4.1 Control by Individual

To this point, this book has considered a number of situations in which the separate identity of a corporation is eroded because it is controlled by individuals. The US check-the-box regime may be viewed as such an example (see above at 1.1.4.2), although it is not based on control as such, but rather the type of entity in question. Under this regime, the income of an LLC may be consolidated with that of a controlling individual. Similarly, under the German *Organschaft* regime (see above at 1.2.3.2), an individual with a business may enter into a profit-sharing agreement with

[438] CAA 2001 (UK) ss. 51D and 51E.
[439] CAA 2001 (UK) s. 51F.

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a controlled corporation. The result is that profits and losses of the corporation will be transferred to the controlling individual.

The UK has no similar broad-based regime that may apply to individuals and controlled corporations. However, there are some isolated examples of the erosion of the separate identity of a corporation controlled by an individual. Section 1.2.3.1 mentioned a rule providing relief from a balancing charge for excess capital allowances when a trade is transferred between members of a corporate group. A similar rule applies when a trade is transferred from an individual to a body corporate controlled by the individual or vice versa.[440] This is most commonly used when incorporating a trade and so it is discussed below at 4.2.1.

As for the market value rule in TCGA 1992 (disposals between connected persons), there is no similar exception for corporations and related individuals as there is for disposal between group corporations, that is, no equivalent to section 171. However, it is possible for an individual to dispose of business assets to a corporation in a non-arm's length transaction on a no gain/no loss basis.[441] The provision does not operate in the opposite direction, that is, a disposal from a corporation to a related individual. This provision is also considered in the context of incorporation, below at 4.2.

At 1.2.2, brief mention was made of an arm's length pricing rule for trading stock sold between connected persons if the seller ceases to carry on the trade in question. As noted at 1.2.3.1, where this rule applies, it is possible for corporation tax purposes for the parties to the transaction to elect to, in effect, sell the stock at cost, that is, no gain/no loss basis.[442] This election is also available for income tax purposes if an individual controls the body corporate in question.[443] The scope of this rule is, therefore, similar to the scope of the rule for capital allowance purposes discussed above. Again, while not limited to an incorporation scenario, this relief is further considered below at 4.2. As with the arm's length pricing rule, however, this election is not available if the transfer pricing rules in TIOPA 2010 apply.[444]

All of these UK erosions of separate corporate identity involve transactions between a corporation and a related individual. These are similar to,

[440] CAA 2001 (UK) ss. 266 and 267.
[441] TCGA 1992 (UK) s. 165.
[442] CTA 2009 (UK) s. 167.
[443] ITTOIA 2005 (UK) ss. 178 and 179.
[444] CTA 2009 (UK) s. 162(2) and ITTOIA 2005 (UK) s. 173(2).

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though far from the same as, erosions in the context of related corporations discussed above at 1.2.3.1. By contrast, however, there is no similar erosion irrespective of transactions. That is, there is nothing akin to the loss reliefs available for group corporations above at 1.2.3.2. Generally, corporations cannot transfer losses or other tax attributes to related individuals or vice versa.

1.2.4.2 Closely Held Corporations

This book has also considered a number of situations in which the separate identity of a corporation may be eroded because it is controlled by a limited number of persons, that is, closely held. Again, the US check-the-box regime and the German *Organschaft* regime can operate in this manner. The check-the-box regime can operate, in principle, irrespective of the number of participators. The *Organschaft* regime can operate where a partnership enters into a profit-sharing agreement with a corporation it controls. The loss transferred from the corporation to the partnership will then be apportioned between the partners in the usual manner for partnership income and losses.[445] However, the partnership must conduct a separate business and the shares must be held as part of that business.[446] This is interpreted to require the partnership to provide services to its controlled corporations that go beyond mere management.

The UK consortium relief regime can produce similar results for corporate joint ventures using a corporation as the vehicle without the requirement that the adventurers constitute a partnership or carry on a business. This relief is particularly flexible and permits trading losses and other amounts for which group relief is available to be transferred between a corporation and substantial corporate shareholders in that corporation. It can operate to treat the corporation, at least with respect to losses, in a similar manner to what might happen if the corporation were a partnership, and so consortium relief erodes the separate identity of the controlled corporation.

Consortium relief involves a corporation surrendering a trading loss or other amounts under the rules for group relief (see above at 1.2.3.2). Consortium relief differs from group relief in a number of respects, including as to who can claim the surrendered amount. Another corporation can claim a surrendered amount if one of three consortium

[445] For example, EStG (Germany) s. 15(1)2.

[446] KStG (Germany) s. 14(1)2.

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conditions is met.[447] These conditions are premised on there being a corporation 'owned by a consortium' and another corporation being a 'member of a consortium'. These concepts are defined in section 153 of CTA 2010. It is important to appreciate that a 'consortium' is purely a tax concept, without commercial legal implications, used to describe a corporation (the 'consortium company') held by substantial shareholders that are also corporations. The substantial shareholders are 'members' of the consortium.

To qualify as a member of a consortium, a corporation must hold at least 5 per cent of the consortium company's 'ordinary share capital' and the holding of all consortium members must be an aggregate of at least 75 per cent of that capital. This means that the maximum number of consortium members is 20, that is, 20 corporations each holding 5 per cent of the shares in the consortium company. The minimum is two. A corporation is not owned by a consortium if it is a 75 per cent subsidiary of another corporation and so consortium relief only applies where group relief is not available. There is no reference to indirect holdings and so in order to qualify as a member a corporation must hold 5 per cent of the consortium company directly.

In order to qualify for consortium relief under any of the consortium conditions, the consortium company must be either a 'trading company' or a 'holding company'. The first is defined as a corporation whose business consists mainly in carrying on trade. A holding company is a corporation whose business consists mainly in holding securities and shares in 90 per cent subsidiaries that are trading companies.[448] The above rules for determining whether a subsidiary is a 75 per cent subsidiary for group relief purposes also apply in determining whether a trading company is a 90 per cent subsidiary. Importantly, a trading company that is a 90 per cent subsidiary of a holding company that is held by a consortium is itself treated as held by the consortium.[449] This means that both the holding company and its 90 per cent trading subsidiaries may be the subject of consortium relief.

The first consortium condition for claiming relief is prescribed by section 132 of CTA 2010. This allows a member of a consortium to claim a portion of, for example, a trading loss of the consortium company. As mentioned, this can work like loss relief for partners in a partnership. However, consortium relief is more flexible because it is also possible for

[447] CTA 2010 (UK) s. 130(2).
[448] CTA 2010 (UK) s. 185.
[449] CTA 2010 (UK) s. 153(3).

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the consortium member to surrender a portion of, for example, a trading loss to the consortium company, so the relief works in both directions. In either case, the quantum of relief is limited to the ownership proportion of the total amount surrenderable.[450] This is typically the percentage of ordinary share capital held by the consortium member in the consortium company.[451]

The second consortium condition allows a member of the same group of companies as a member of the consortium to claim a portion of, for example, a trading loss of the consortium company.[452] So, if A Co is a 75 per cent subsidiary of B Co and B Co holds 20 per cent of the ordinary shares in a consortium company, a loss of the consortium company may be transferred to A Co. The amount that may be claimed by A Co is again limited to 20 per cent of the consortium company's loss (and not 75 per cent of 20 per cent).[453] The third consortium condition involves the reverse scenario. This condition permits a loss incurred by a member of a corporate group to be passed to a consortium company where the relevant holding of shares in the consortium company are held by another group member.[454] In the example, this would allow part of a loss of A Co to be claimed by the consortium company. Again, the quantum of relief would be limited to 20 per cent of A Co's loss.[455]

Consortium relief is an interesting and flexible form of relief that can be particularly useful in the context of joint ventures. In this area, it alleviates much of the tax planning that occurs in other countries in seeking loss relief for joint venture partners with respect to the activities of the joint venture. It also mitigates the *knife-edge* nature of group relief. In many cases, if a corporate shareholder falls just short of group relief it will be entitled to consortium relief, making the importance of being within a group of companies or not less dramatic. However, like group relief, consortium relief is largely restricted to revenue losses. There is no equivalent to consortium relief with respect to capital losses, reinforcing the fragmented nature of the UK corporate tax system.

[450] CTA 2010 (UK) ss. 143 and 144.

[451] If lower, consortium relief may be limited to the proportion of profits available for distribution to equity holders of the consortium company, the proportion of assets that would be available to equity holders on a winding up of the consortium company or the proportion of voting power held directly in the consortium company. For example, see CTA 2010 (UK) s. 143(3).

[452] CTA 2010 (UK) s. 133(1).

[453] CTA 2010 (UK) s. 145(2).

[454] CTA 2010 (UK) s. 133(2).

[455] CTA 2010 (UK) s. 145(3).

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1.2.5 Interface with Personal Income Tax

This section is concerned with special rules for calculating the corporation tax base that exist fundamentally because of the nature and existence of a corporation. It has considered some general rules and, in particular, the relationship between the corporation tax base and financial accounts, which most corporations must prepare. It has also considered special corporation tax base rules that exist to reinforce the separate identity of a corporation and special rules that erode the separate identity of corporations related to other persons. This final section considers special corporation tax base rules that might exist because of the relationship between a corporation and individuals and, in particular, the interface between the corporation tax base and the personal income tax base.

As noted at the start of this section, this interface may be caused by events occurring during the existence of a corporation. This happens most clearly when a corporation distributes profits to an individual, and so pre-empts Chapter 2, but it can also arise in other contexts. A different type of interface occurs in the face of special tax base rules designed with individuals in mind. Many of these rules obviously don't apply to corporations and so the focus is on whether corporations are eligible for any simplified tax base rules that may be available to individuals.

1.2.5.1 Interface through Events

There are a number of events that may occur during the existence of a corporation where the corporation tax base interfaces with the personal income tax base. This interface may have implications for the design of a corporate tax system. The most important of these interfacing events are considered later in this book. These include the distribution of corporate profits (Chapter 2), the incorporation of a business (Chapter 4) and the sale of shares in a corporation (Chapter 5). The matters discussed in this section are discussed in more detail in those chapters, but it is useful to preface that subsequent discussion with an overview of the interface issue.

One peculiar feature of a corporation is that its income is derived twice. It is derived once by the corporation as profits and a second time by its members on distribution. This is the dual nature of corporate income and reflects the artificial nature of corporations. This means that corporate income is first measured by the corporation tax base and then, on distribution, by the personal tax base. A problem, or at least an issue, for a corporate tax system is the extent to which these two tax bases coincide.

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Inevitably, in practice they do not, and this has consequences. It means that some amounts might constitute taxable income just at the corporate level, some just at the shareholder level, but most at both.

There are only two main ways to remedy this dislocation. One is to make the corporation tax base reflect the personal tax base for dividends. Presuming that all dividends are taxable to individuals as such, this largely means making the corporation tax base reflect profits that are available for distribution under corporate law. For many countries, this would involve the corporation tax base reflecting profits declared in financial accounts, as discussed above at 1.2.1. The second main way to remedy the dislocation between the corporation tax base and the personal tax base is to have the personal tax base reflect the corporation tax base, that is, only tax dividends to the extent of profits included in the corporation tax base. This option does not, of itself, suggest a scope for the corporation tax base, for example alignment with financial accounts. In either case, hidden profits distributions would still cause difficulties. This is discussed further at 2.2.2.

Neither of these approaches involving the interface between the corporation tax base and dividends suggests that the tax base for corporate activities should be the same as it is for individuals conducting similar activities. However, such an alignment might be suggested by the potential to incorporate a business of an individual. If the tax system wishes to pursue neutrality, it might be suggested that the tax base faced by an individual when conducting, for example, a trade should be the same as that faced by a corporation. Otherwise, dislocations between these two tax bases might act as an incentive or disincentive to incorporate the business. An individual might accept that the tax rate is different on incorporation. However, the individual might be more surprised to find that different amounts are included in calculating income from the business or different amounts deducted in that calculation depending on whether the business is conducted by the individual or a corporation.

A different type of interface occurs between the personal tax base and the corporation tax base when an individual sells shares in a corporation. The value of shares typically depends on assets held and prospects of future profits at the corporate level. Assets supported by retained profits may represent amounts that have been included in the corporation tax base and taxed as such. So, to the extent that gains on the disposal of shares included in the personal tax base reflect profits included in the corporation tax base, there is an interface between the personal and corporation tax bases.

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This interface is more complex than those occurring on distribution or incorporation and its implications are not clear. It might suggest that gains on the disposal of shares should be taxed only to the extent they reflect retained profits of the corporation. However, it could also suggest the reverse, that is, that gains on the disposal of shares should only be taxed to the extent that they do not reflect retained profits. Another alternative is to suggest that the corporation tax base should include amounts to the extent realised on a disposal of shares in the corporation in question. For example, this might mean that when a corporation is sold (share sale), it must include all unrealised gains and losses in its corporation tax base, for example, treat all assets as realised at market values. What is clear is that there is some reason for further investigating the difference between gains on the disposal of shares reflecting retained profits included in the corporation tax base and such gains that do not reflect retained profits.

1.2.5.2 Special Rules for Individuals: Focus on Simplified Tax Base

This book focuses on special tax rules that are required because of the particular nature of a corporation as an artificial person. It presumes that such rules can be distinguished from other rules that cannot be identified as special corporate rules. Just as rules might be identified as special corporate rules, income tax laws include numerous rules that are required because of the peculiar nature of individuals. These rules can relate to an individual's dependency, ability to marry, ability to consume, ability to have leisure time, etc.

There is a fundamental question as to where to draw the line between special corporate rules and general rules. This section has been concerned with special corporate rules for calculating the corporation tax base. Similarly, there is a fundamental question as to where to draw the line between special rules for individuals and general rules. As with the special corporate rules, in some cases the divide will be obvious. Tax rules concerning dividends are clearly special corporate rules. Rules on employment income are clearly rules for individuals (although there may be an interface in the context of corporate intermediaries), as are rules on disposals between married couples. However, at the margins the differences between special corporate rules and special rules for individuals, at each end, and general income tax rules, in the middle, are not so clear. For example, are rules on a basic exemption and progressive tax rates special rules for individuals or are they general rules that should be applied to corporations as well? This particular issue is discussed further below at 1.3.2.

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The structure of an income tax law may draw clear lines between general tax base rules, special corporation tax base rules and special individual tax base rules. The US income tax law is a good example. Part VI of IRC is entitled 'Itemized Deductions for Individuals and Corporations'. Part VII goes on to specifically provide for 'Additional Itemized Deductions for Individuals' and Part VIII 'Special Deductions for Corporations'. By comparison, Germany has some rules in chapter 1 of Part Two of the KStG that modify the personal income tax base rules as they apply to corporations. The EStG does not specifically identify rules only applicable to individuals, although by their nature this must be true of many provisions.

The confused structure of the UK income tax law was discussed in the introduction and the entire duplication of the personal and corporation tax bases was noted above at the start of this section. This makes it difficult to assess which rules in ITEPA 2003, ITTIOA 2005 and ITA 2007 (personal income tax base) are replicated in CTA 2009 and CTA 2010 (corporation tax base). Even if it is found that a particular rule is replicated, the rule may be modified in one context but not the other, or at least the rules are most commonly not expressed in precisely the same language. Some rules are clearly applicable to one tax base but not the other. For example, the loan relationship rules, the derivate contract rules and the intangible fixed assets regime only apply to corporation tax.[456]

As noted at the start of this section, in China also there is no direct relationship between the personal tax base in the IITL and the corporation tax base in the EITL. However, unlike the UK, these separate rules in China do not have a common origin and so are very different from each other. In China, it is difficult to discuss general income tax rules applicable to both individuals and corporations. Structurally, the rules for individual and corporations are distinct.

The discussion under this section has focused on business income of corporations. The question for present purposes is whether, in principle, there are special tax rules for calculating an individual's income from a business that should not apply to a corporation calculating income from a business. Clearly, there are many tax rules that apply to the calculation of business income because of a relationship with an individual. An example is the denial of a deduction for business entertainment

[456] Another example is the concessionary tax treatment of research and development expenditure in Part 13 of CTA 2009 (UK), including the ability to claim research and development credits.

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expenses. However, this rule does not suggest that it should be applied differently depending on whether an individual or a corporation is conducting the business.[457]

However, there is one issue in the context of the calculation of income from a business that requires a bit more consideration. A number of countries have a presumptive tax for small business or at least a simplified method of calculation of business income, especially for individuals below the threshold of registration for VAT. Should such simplified tax base rules also apply to a corporation?

There are reasons to suggest that a simplified method of calculating business income is a matter peculiar to individuals. Such rules are often implemented because of the difficulty that individuals with small businesses have in calculating their income. Sophisticated calculations that comply with accounting standards are beyond the average small business owner. Unlike registered companies, individuals are often not required by law to prepare accounts that meet these standards. To require them to do so for tax purposes would force many to engage professional assistance, and that would impose additional costs that disproportionately increase the compliance burden for individual businesses.

By comparison, a corporation is typically required by corporate law to prepare financial accounts to a given standard (see above at 1.2.1) and inevitably this involves engaging a professional. The additional costs in getting the professional to adjust the accounts for tax law purposes may be comparatively minimal. Further, despite a corporation having a relatively small business operation, its owners and controllers may be sufficiently sophisticated to prepare proper accounts or have other activities that justify such accounts. In the end, whatever the arguments for a simplified tax base for small businesses of individuals, the arguments are less strong for extending any such rules to corporations. If a simplified regime is available to individuals but not corporations, there will be a disjuncture between the personal tax base and the corporation tax base.

A main issue for persons conducting small business is whether they are required to use an accrual base for calculating their income from the business. Further issues of particular importance are the manner in which

[457] For example, the limitation of entertainment expenses in IRC (US) s. 274 and EStG (Germany) s. 4(5)2 applies to both individuals and corporations. Because of the split nature of the personal and corporate tax bases in the UK, it requires two rules. The rules have the same origins but are showing signs of divergence; ITTOIA 2005 (UK) s. 45 and CTA 2009 (UK) s. 1298. In China, EITR Art. 43 has a limitation on entertainment expenses, but there is no equivalent in the IITL or the IITR.

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depreciation is calculated and the rules for accounting for trading stock. Tax laws that have a weaker connection between financial accounts and the business tax base have a greater propensity to have flexibility as to whether an accrual system must be used.

The US has a weak connection between financial accounts and the business tax base (see above at 1.2.1). In the US, small businesses may account for business income on a cash basis.[458] As a general rule, corporations are not permitted to use the cash method of accounting.[459] There is no dedicated regime for small business. However, the US does grant an immediate expensing allowance for certain tangible assets and computer software. It is presently a maximum of $1,000,000 and is available to both individuals and corporations.[460]

Australia, which also has a weak connection between financial accounts and the business tax base, provides a good example of a country with special tax rules for small business.[461] These rules largely pertain to concessionary methods of calculating capital allowances (depreciation) and accounting for trading stock. A former requirement for cash accounting was repealed in 2006, although that is still an option. These rules apply to 'entities' and so both individuals and corporations may qualify.

By contrast, as discussed above at 1.2.1, Germany and the UK have stronger links between financial accounts and the business tax base. As a result, in Germany, most business taxpayers must use the accrual method, but there is a modified system for taxpayers that are not obliged by law to maintain accounting records (largely independent services and farming).[462] As corporations are required to maintain accounts, this option is not available to corporations.

The UK is also a country that has a substantial link between financial accounts and the business tax base, at least with respect to revenue amounts. Both individuals and corporations are required to calculate their profits from a trade in accordance with generally accepted accounting principles, subject to tax law adjustments.[463] The result is essentially

[458] IRC (US) s. 446.
[459] IRC (US) s. 448.
[460] IRC (US) s. 179. Until 2023, s. 168(k) provided for immediate expensing of certain short-term capital assets and is being phased out until 2027. It also applies to both individuals and corporations.
[461] Income Tax Assessment Act 1997 (Australia) Division 328.
[462] EStG (Germany) s. 4(3). Under the Commercial Code (HGB) (Germany) s. 238 'traders' are required to maintain accounts. There is an exception for very small businesses; s. 241a.
[463] ITTOIA 2005 (UK) s. 25 and CTA 2009 s. 46. The latter provision was discussed above at 1.2.1.

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an accrual accounting-based approach. In 2013 the UK introduced an exception whereby individuals with a turnover of £150,000 or less may elect to use cash basis accounting for tax purposes.[464] There is no equivalent election for corporations. An annual investment allowance for capital expenditure was introduced in the UK in 2008. One of its publicly stated benefits was that it would effectively relieve 95 per cent of businesses from making complex writing down allowance calculations. Despite the fact that corporations must calculate depreciation for financial accounting purposes, the annual investment allowance is equally available to individuals and corporations.[465]

In China, corporations calculate their taxable income on an accrual basis.[466] By contrast, there is no similar requirement for individual entrepreneurs, and individuals who do not maintain accounting records may be taxed on a deemed profits basis.[467] These are separate systems for individuals and corporations.

1.3 Tax Treatment

This section builds on the matters considered in sections 1.1 and 1.2. It presumes that a corporation has been identified for tax purposes and, importantly, that the corporation is, as a legal matter, capable of having income for tax purposes; that is, it is presumed that the entity identified is capable of making and receiving payments and so can have income or profits. Accordingly, what is not considered is the taxation of income of entities that are ignored for tax purposes (purely transparent). It is also presumed that the quantum of the corporation's income for a given tax period has been settled. This means that any special rules for determining the tax base of corporations, such as those discussed in section 1.2, have been accounted for.

This section is concerned with the deceptively simple question of how the identified income of the corporation should be taxed. A preliminary question is whether corporate income should be taxed at the point it is derived, as opposed to when it is distributed or at some other point in time. It is often argued that corporations are inappropriate subjects of taxation, primarily because they do not bear the burden of taxes imposed

[464] ITTOIA 2005 (UK) s. 25A.
[465] CAA 2001 (UK) s. 51A.
[466] EITR (China) Art. 9.
[467] IITR (China) Arts 6(9) and 15.

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on them, whether direct or indirect taxes.[468] This, however, confuses the issue. The preliminary issue is not so much whether corporations should be taxed with respect to their income when it is derived, but whether that income should be taxed to *anyone* when it is derived.

The bottom line is that if other forms of return on personal savings are taxed then it will be necessary to tax the retained profits of corporations. This will be necessary both from an equity perspective and an efficiency perspective. If it were otherwise, corporations would provide a simple means of deferring, potentially permanently, the taxation of personal income.[469] This is a consequence of the realisations nature of the income tax. The under-taxation of corporate income when derived (especially its non-taxation) is commonly referred to as the 'corporate tax shelter' problem.

Governments are aware that if they do not tax corporate income effectively the result will be an erosion of the personal income tax base. The erosion can be substantial, and this can have critical fiscal consequences. On average, OECD countries raise about 24 per cent of their revenues from the personal income tax; in Germany and the UK it is over 27 per cent and in the US over 40 per cent. If social security contributions are taken into account, the average is 60 per cent. By comparison, the taxation of corporations with respect to their income raises about 10 per cent on average; in Germany it is not much more than 5 per cent, in the UK about 7 per cent and in the US 5.5 per cent. This can be much higher in resource-rich countries, for example, in Australia it is more like 17 per cent. These figures have been robust over the past few decades. The figure is even higher in China, where the enterprise income tax accounts for over 20 per cent of aggregate tax revenue. There is much less reliance on the individual income tax in China, which only accounts for less than 5 per cent of aggregate tax revenues.[470]

The taxation of corporate income when it is derived involves two primary issues. The first is the identification of the tax subject, that is, who is taxable with respect to corporate income. Just because a corporation has income does not mean that it has to be the tax subject with respect to that income. After all, corporations are legal fictions. The second issue is the rate at which retained corporate profits should be taxed. This issue may be informed by the first, that is, the selection of the tax subject. This section discusses these issues in three subsections. Section 1.3.1 considers

[468] See references in the introduction, above at footnote 35.
[469] Generally, see Harris (1996, 100–12) and the references cited therein.
[470] See OECD (2010–).

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the options and factors in selecting who is to be taxed with respect to corporate income at the point it is derived. The two main approaches are to tax either the corporation itself or the members/controllers of the corporation. Each of these is dealt with in sections 1.3.2 and 1.3.3, respectively.

1.3.1 Selecting the Tax Subject

1.3.1.1 Corporate Taxation: In Search of a Philosophy

How should corporate income be taxed when it is derived? While this may be a philosophical question, it has practical consequences. How do you tax something that is a legal fiction and fit it into an income tax that predominantly applies to individuals? For some, this may be a question of why the legal fiction was created in the first place. For others, it is a question of the behaviour of the legal fiction. Whatever the approach, it is clear that there are a number of philosophical bases for the taxation of corporate income when derived. These bases are competing, sometimes overlapping, but at other times inconsistent. There is no dominant philosophy, and this is borne out in the divergent approaches of countries to the taxation of corporations. It is, however, useful to consider some of the main possibilities because this assists in assessing various approaches to particular issues discussed later in this book.[471]

A simplistic approach is to suggest that corporations are persons and, therefore, they should be taxed with respect to their income like individuals and at the same (progressive) rates. The trouble is, a corporation is really an amalgam of individual stakeholders, and even if corporations exist in some economic sense, they are not the same as individuals. Many of the features of human existence that are reflected in the tax system, such as the need for food and shelter, the existence of family relations and aging, do not apply to corporations.

A dominant philosophy for the taxation of individuals with respect to their income is that taxes should be imposed according to *ability to pay* (sometimes referred to as tax 'capacity' or 'faculty').[472] This is a very old principle and can have religious connotations.[473] It is also sufficiently

[471] For an economic view on why we tax corporate income, see Nicodème (2008, 2–5).

[472] Generally, see Harris (1996, 14–27) and the references cited therein. See also Dodge (2012).

[473] For example, the English poll tax of 1380 required individuals to pay tax according to their 'ability' and there was a similar prescription in local taxation at the time. Similarly, the poor laws beginning in 1563 and the famous ship writs of Charles I of England beginning in 1634 expressly referred to 'ability'. See Harris (2006, 45–46, 53, 74–75 and 80–81).

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vague so that it can be adapted across time and societies. Some countries have incorporated the principle in their constitutions either directly or indirectly through a requirement for equality.[474]

Ability to pay is broadly accepted to require each person in a given society to make the same comparative (equal) sacrifice or suffer the same (equal) burden in paying taxes.[475] This leads to the justification for progressive as opposed to proportional taxation. As a person's income or wealth increases, the utility of the person's next dollar (etc.) decreases. So, a person derives less utility from the person's millionth dollar than they do from their thousandth dollar. This justifies taxing the millionth dollar at a higher rate than the thousandth dollar so as to equalise the sacrifice or burden in paying the tax. The result is progressive taxation.

Even if ability to pay is legally applicable to corporations (e.g. by constitution), there is a certain irrationality in attempting to do so. The notion of sacrifice suggests an investigation of the incidence of taxation, that is, it is the 'burden' of taxation that should be equalised and a tax that is shifted or passed on to another person is no burden at all. While incidence is a particularly slippery concept, as noted in the introduction, it is generally agreed that corporations do not bear the burden of taxation. The incidence of a tax imposed on a corporation is not the corporation itself but the individuals engaging with or having an interest in the corporation. At this level, it makes no sense to attempt to apply the concept of ability to pay to corporations. Therefore, ability to pay is at best a flawed philosophy for the taxation of corporations.

The fact that corporations are artificial, do not exist per se and so do not bear the burden of taxation may suggest that corporations should not be taxed with respect to their income. As mentioned above, this does not mean that corporate income should not be taxed at all when it is derived, just that it should not be taxed to the corporation. So, this would be a sort of negative philosophy, 'don't tax the corporation'. While the corporation

[474] For example, the Brazilian Constitution Art. 145 specifically requires taxes to be 'graded according to the economic capacity of the taxpayer'. The German Constitutional Court has interpreted the constitution requirement of equality (Art. 3) as incorporating the ability to pay principle; see Arnold, Ault & Cooper (2019, 97). Article 19(3) confirms that this also applies to 'domestic legal persons', that is, corporations, and see Anzinger (2017, 12). The German constitutional court actively applies the principle of equality in regulating tax rules. For a recent example of a tax violation of this principle, see Hoke (2022). Similarly, with respect to Japan, see Arnold, Ault & Cooper (2019, 162–63), and Italy and Spain, see Vanistendael (1996, 22–23).

[475] Interpreting ability to pay to require equality of sacrifice was famously advocated by John Stuart Mill; see Mill (1871, 392).

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would not be taxed, the usual suggestion is that the shareholders in the corporation should be taxed with respect to corporate income, irrespective of distribution, that is, a transparent treatment.[476] From a practical perspective, this is only possible in certain circumstances and is discussed further below at 1.3.3. So inevitably, countries impose income tax on corporations, although maybe not all corporations.

Another potential philosophy is that corporate taxation must be competitive. Corporate taxation should not be such as to deter foreigners from investing in the local economy. It is presumed that foreign investors are marginal investors and any attempt to tax a standard rate of return (such as a risk-free interest rate) will deter such investment. This is because a standard rate of return is set globally and any attempt to tax it will cause foreigners to invest elsewhere. If, however, an above standard rate of return (economic rent) can be derived locally, that is an appropriate subject of taxation. This is because after taxation (presuming taxation is less than 100 per cent) the foreign investor is still left with a better return than a standard rate of return.[477]

This type of analysis regarding economic rents is overly simplified. There are different types of economic rents and some, if not all, types of economic rents are also subject to international competition.[478] For reasons discussed in the introduction, corporation tax is an indirect tax, a source-based tax. It is a primary mechanism by which countries tax the return to foreign investors derived from activities within a country. Therefore, the tax on corporate income is also a primary mechanism by which a country taxes economic rents derived from that country. Indeed, if interest expense were freely deductible and subject to limited or no taxation at source, that interest may represent the standard rate of return for the activities in question. As the taxation of corporate income is a tax on profits after the interest deduction, that taxation can approximate a tax on economic rents.[479]

There are problems with adopting taxation of economic rents as a philosophy for the taxation of corporate income. It may indicate something about the taxation of domestic source income derived by foreigners but

[476] See Harris (1996, 107–108) and the references cited therein.

[477] For a lawyers' guide to the taxation of economic rents, see Passant (2011). And see Shaviro (2021).

[478] For example, see IMF (2019, [32]).

[479] Some, and in particular the UK Institute for Fiscal Studies, have championed formalising this position by providing an exemption for the standard rate of return on corporate equity (allowance for corporate equity or 'ACE'). For a proposal to this effect, see Mirrlees et al. (2011, chapters 17 and 18). And see below at 2.4.2.1.

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indicates little about purely domestic taxation or the taxation of residents with respect to their foreign source income. It could be that the taxation of economic rents is also adopted as a domestic tax philosophy, which might result in no taxation, or at least reduced taxation of capital income.[480] However, this is contrary to generally understood notions of the principle of ability to pay and would, in effective require that that principle be discarded (or interpreted in a dramatically different manner). This is particularly problematic and speculative for countries where the ability to pay principle is constitutionally entrenched.[481]

It is difficult to apply the ability to pay principle to corporations because of their artificial nature. Because of that nature, it is inevitable or at least a feature of corporations that income derived by a corporation becomes the income of individuals at some point after it is derived by the corporation. This typically occurs on division or distribution of profits, which is a separate taxing event from the deriving of profits (see below at 2.3). On this basis, a corporation may be viewed as simply a vehicle through which individuals derive income which, when corporate profits are retained, involves the temporary allocation of corporate income to the corporation for tax purposes. This is consistent with the nature of a corporation as a collective investment vehicle, can be consistent with the realisation basis of the income tax (see Introduction) and is not inconsistent with the ability to pay principle.[482]

As a result, it is commonly suggested that the philosophy of the taxation of retained corporate profits should be taxation that acts as a temporary surrogate for personal income taxation.[483] When corporate profits are distributed to individuals, taxation should be adjusted in accordance with the ability to pay principle. It was this type of philosophy that caused the proliferation of imputation systems from the 1960s through the 1990s,[484]

[480] For such a proposal (rate of return allowance or 'RRA'), see Mirrlees et al. (2011, chapter 14).

[481] It is possible to limit taxation of economic rents to the taxation of the domestic activities of foreigners. In this context, the ability to pay principle could continue to require the holistic taxation of income in a purely domestic setting. Symmetry might then require that residents only be taxed on their standard rate of return with respect to foreign investments.

[482] Regarding the need to tax corporations to prevent tax sheltering by individuals and promote the principle of ability to pay, see Fleming, Peroni & Shay (2017, 1697–98).

[483] Generally, see Harris (1996, 102–104). Bank (2014, abstract) refers to the 'origins of the corporate income tax as a proxy for reaching shareholder income'. And see Devereux et al. (2021, [2.1.2]). At [3] there is a somewhat superficial attempt (a 'short cut', see p. 63) to discount the serious issues raised by the interface between corporate and individual taxation (with what appears to be a particular outcome in mind), especially the use of corporations to derive labour income, as to which see below at 1.3.3.3, and political pressure to tax capital income.

[484] See Harris (2010).

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although it was clear as a philosophy from the introduction of the modern income tax in the UK in 1799. Indeed, historically, corporation tax as a temporary surrogate for personal income tax may be viewed as the dominant philosophy of the corporation tax.

Globalisation has challenged this domination dramatically; some might say fatally.[485] The world now involves individuals, resident in a particular country, directly or indirectly investing in corporations located in and conducting activities in countries all around the globe. In this context, it is not clear which country's corporate taxation should be acting as a surrogate for which country's individuals. Added to this is the particular difficulty in taxing capital income, issues regarding the exempt taxation of retirement savings (one of the primary forms of saving by individuals) and suggestions that returns on capital should not be taxed at all. These issues assault not just the philosophy of corporation tax as a temporary surrogate for personal income taxation, but the very principle of ability to pay.

It would be naive to suggest that ability to pay as the dominant philosophy of taxation is or will become irrelevant. Economics pays scant regard to this principle except to the extent that it constitutes a limitation on possible approaches to taxation. This is because ability to pay is a moral philosophy and not an economic one. It has been the guiding principle of taxation since the Middle Ages (and earlier) and is still under constant discussion. Perhaps globalisation has caused such a fundamental shift in our economies that the principle of ability to pay must be replaced with economic principles. However, it seems more likely that the principle of ability to pay will be adapted (as it has in the past) to the new circumstances.

The above discussion considered only the most widely discussed options for a philosophy of corporate taxation. There are other possible philosophies. For example, it might be suggested that the taxation of corporate income should more generally be governed by a principle of competition. Taxation of economic rents might have something to do with this, but competition may more broadly govern the structure of a corporate tax system, although the OECD's global minimum tax project might be viewed as an attempt to restrict or regulate this. It might also be suggested that corporate taxation should be governed by the need to promote innovation or wealth maximisation. More recently, economic sustainability and green growth are having a serious impact on the design of tax

[485] See Harris (2010).

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systems and perhaps these might in the future serve as a basic philosophy for corporate taxation. There are other possibilities.

1.3.1.2 Options for Tax Subject

It is presumed that corporate profits should be taxed under an income tax irrespective of whether they are distributed, if for no other reason than to protect the individual income tax base from unacceptable deferral.[486] If retained corporate profits are to be taxed, the next issue is *who* should be taxed. As mentioned, just because a corporate tax system recognises a corporation as a person and allocates income to the corporation does not mean that the corporate tax system will necessarily tax the corporation with respect to its income. Clearly, however, a corporation may be taxed with respect to its income, and this is the dominant approach. Here the primary issue is the rate at which corporations should be taxed, discussed below at 1.3.2.

Alternatively, a corporation's shareholders may be taxed with respect to the corporation's retained profits. Here the rate at which shareholders should be taxed is less of an issue. It is presumed that they would be taxed at regular tax rates (if the shareholders are individuals). The more difficult issue is how a single amount, the profits of a corporation, should be allocated among multiple shareholders. This has two features; identifying the group that is subject to allocation and determining the basis of allocation. These issues are explored further below at 1.3.3 in the context of practical examples.

Corporations and shareholders are not the only possible subjects for the taxation of retained corporate profits. As noted above at 1.1.3.1, corporations generally have two main organs, the shareholders in general meeting and the board of directors. So, the board of directors or at least the management of a corporation is another possible tax subject. Even if management is not the primary tax subject in this regard, it is often a secondary or residual tax subject. Corporations must act through individuals and so, at a physical level, corporations are incapable of paying taxes. It is typically a corporation's management that causes the corporation to pay tax. Therefore, if a corporation fails to pay tax, there is reason to make management personally liable, at least in the case of solvent corporations.[487]

[486] Generally, see Harris (1996, 49–53).

[487] *Holland* v. *RCC* (2010) [2010] UKSC 51 (SC) involved an argument that a particular individual was a de facto director of a group of corporations that paid insufficient taxes. The actual director of these corporations was another corporation of which the individual

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It is also possible to simultaneously select more than one option for taxation of retained corporate profits. So, there have been examples of corporations being taxed with respect to their income and at the same time shareholders of the corporation being taxed with respect to that income. This might be done to increase the overall tax on retained profits to the rate of the shareholders, particularly where the shareholders are subject to progressive tax rates higher than the corporate tax rate.[488]

Selection of a particular tax subject for the taxation of retained corporate profits may depend on the particular circumstances of the corporation in question. This is an area where the sub-categorisation of corporations (see above at 1.1.2 and following) is particularly relevant. The ability of shareholders in a closely held corporation to coordinate in order to control the corporation was discussed above at 1.1.3.2. Shareholders in closely held corporations usually have the ability to control the distribution policy of such corporations. Often, they have a separate shareholders' agreement addressing this issue. In other words, shareholders in closely held corporations have an ability to call for distributions or divisions of profits at their will. It is a small step to suggest that such shareholders have a personal *ability to pay* tax out of profits retained by the corporation.

The situation is different with widely held corporations. Here, while the shareholders have a collective ability to control the directors (and so distribution policy), they have no practical mechanism for acting collectively. If realisation is accepted, there is no ground for suggesting that a small shareholder in a large corporation realises income where the corporation retains profits. The shareholder has no *ability to pay* tax out of those profits.

By contrast, the control possessed by shareholders in closely held corporations may be considered to give rise to a form of constructive receipt or realisation. Accordingly, there seems substantial justification for taxing shareholders in a closely held corporation with respect to

was a director. The corporations were set up to be used as corporate tax shelters for other individuals who were seeking access to the UK's small profits rate of corporation tax. The UK tax administration proceeded to argue that the individual was personally liable for the taxes by reason of causing the corporations to distribute dividends while insolvent. In a split decision, the UK Supreme Court held the individual was not a de facto director.

[488] Such an allocation was made to active shareholders under the former Norwegian imputation system, see Harris (1996, 730). A similar allocation was made under the former UK surtax apportionment which operated between 1922 and 1988, see Harris (2011, particularly at 199).

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retained profits of the corporation, although this is not without practical difficulty. There is less justification for doing so in the context of widely held corporations. In the absence of fundamentally altering the nature of income taxation, there is little choice but to tax widely held corporations directly with respect to their retained profits. A problem with taxing widely and closely held corporations differently is that it puts pressure on the definition of each. As noted at 1.1.5.2, this is a spectrum issue and any line drawn between these different types of corporations must be arbitrary.

1.3.2 Taxing the Corporation

Inevitably, countries that impose income tax will tax corporations with respect to their income. That is discussed in this section and the primary issue is the rate at which the corporation is taxed. There is no such thing as a 'correct' corporate tax rate, only a rate that may be influenced by certain factors when it is selected. This section first discusses the main factors for consideration in selecting a corporate tax rate. The discussion then draws on practical examples in considering the options in selecting a corporate tax rate.

1.3.2.1 Factors in Selecting a Corporate Tax Rate

Factors that may be relevant in selecting a corporate tax rate for retained profits can be broken down into two fundamental categories, which are the focus of the following discussion. First, there is the issue of how the corporate tax rate affects the interface between the tax treatment of retained profits and other aspects of the income tax system, particularly the personal income tax. This discussion considers distortions caused by selection of a particular corporate tax rate; no corporate tax rate is entirely neutral. Second, philosophical issues of the type described above at 1.3.1 may be considered in selecting a corporate tax rate. These issues provide some insight into how and the extent to which corporate tax rate distortions may be addressed.

Interfacing Issues The taxation of retained profits in the hands of a corporation interfaces with any situation that is substitutable with such retention. There are three interfaces that are particularly sensitive to the selection of a corporate tax rate. At a basic level, there is the interface involving selection of the vehicle through which income is derived. Here the issue is how the taxation of retained profits under the corporation tax

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compares with the taxation of retained profits derived directly or through other types of artificial intermediaries.

At a more direct level, retained profits represent (at least in prospect) a return on one particular manner in which a corporation may be financed, that is, equity capital, a return for shareholders. Here the issue is how the taxation of retained profits under the corporation tax compares with the taxation of the return on the other major manner in which a corporation may be financed, that is, debt capital, a return for debenture holders. At the most specific level, retained profits represent a return that can be, but which is not, presently, paid to shareholders. Here the issue is how the taxation of retained profits under the corporation tax compares with the taxation of distributed corporate profits.

Some of these issues have been touched on above at 1.2.5 in the context of the interface between the corporation tax base and the personal income tax base. In particular, that discussion considered dislocations that might occur on incorporation of a business if the two tax bases are not the same. Similar dislocations occur if the corporate tax rate is not the same as that faced by a sole proprietor. In simple terms, if the corporate tax rate is lower than the regular tax rate faced by a sole proprietor, there is an incentive to incorporate the business. If the corporate tax rate is higher, there is a disincentive to incorporate. Similar issues arise where the business is conducted by some other entity, for example, a partnership or trust. As partnerships are typically transparent, the issues will be largely the same as for sole proprietors. The taxation of trusts is beyond the scope of this book.

The same analysis applies as to the form of financing, that is, whether debt or equity. The distinction between debt and equity financing (or lack thereof) is discussed below at 2.1.2. In principle, the return on debt is obligatory whereas the return on equity financing is typically discretionary. This means there are two points at which the taxation of the return on debt and equity can be compared (presuming, as the present discussion does, that there is no adjustment of interests in the corporation). These are where the profits are retained (the present discussion) and where the profits are distributed (discussed below at 2.3 and 2.4). So, unless retained profits are taxed at the same rate as interest in the hands of the financier, there is either an incentive or disincentive to finance with debt comparative to equity.

The same analysis applies with respect to the decision to retain or distribute profits. If the profits are retained, this is reinvestment in the corporation in question. If the profits are distributed, the investor has a number

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of options. The investor may consume the distribution, may reinvest in the distributing corporation or invest in some other form of saving. If the investor's intention is to reinvest in the same corporation, then the level of tax on retained profits when compared with the level of taxation on distributed profits is highly relevant. If the corporate tax on retained profits is higher, there is an incentive to distribute. If the corporate tax on retained profits is lower, then retaining profits is the favoured reinvestment strategy.

However, the difference between the taxation of retained profits and distributed profits can have an impact even where the investor prefers to engage in consumption or investment elsewhere. If the taxation of retained profits is sufficiently low by comparison to the taxation of distributions, this may cause the investor to choose to not engage in consumption. Similarly, if the taxation of retained profits is sufficiently low, there will be more to reinvest in the corporation in question than there would be in some other investment, that is, the difference between the two forms of taxation. This may cause retaining profits in the corporation to be a better investment than the alternate investment, even if the rate of return on the alternative is greater than what the corporation can earn on the retained profits.

Added to this complex mix of factors regarding the form of financing and whether to retain or distribute profits is the fact that the investor may have little or no influence over these factors. This may particularly be the case in widely held corporations where ownership and control are separated. The management of the corporation may not provide a comparable debt option to the option of equity in the corporation. Similarly, the management of the corporation may decide to retain profits in the corporation irrespective of what a particular investor would prefer. At a collective level, management of a corporation is likely to be influenced by market preferences, but these may not reflect the preferences of a particular investor. Each of these options becomes increasingly substitutable in corporations that are controlled by the investor in question, that is, in the context of closely held corporations.

Philosophical Issues With these interfacing issues in mind, it is useful to turn to some of the philosophical issues considered above at 1.3.1 and assess whether any of them are instructive when selecting a corporate tax rate for retained profits.

Same Rates as Individuals One philosophy was to subject corporations to the same (progressive) tax rates as individuals. The discussion at 1.3.1

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raised certain conceptual objections to this approach, which can also be illustrated by reference to the interfacing issues. If individuals are subject to progressive rates and corporations are subject to the same progressive rates then, without more, there is an incentive to incorporate, finance with equity and retain profits.

These incentives arise because individuals, through the use of a corporation, could indirectly benefit from more than one set of progressive tax rate thresholds. This would encourage income splitting in a similar manner as the separate taxation of spouses encourages income splitting. Further, it could encourage an individual to use multiple corporations. To counter this, it is possible to apportion one set of progressive tax rate thresholds between an individual and the individual's controlled entities. This could be complex (see below at 1.3.2.2), especially where a corporation is closely controlled by a number of persons. In any case, progressive taxation of corporations causes serious questions as to what should happen when a corporation distributes profits, that is, how the shareholders should be taxed. The progressive tax rate of the corporation is unlikely to be the same as that of its shareholders. The taxation of distributions is considered below at 2.3 and 2.4.

This philosophy, that is, taxation of corporations at the same rates as individuals, might be reversed. It might be suggested that other forms of business entity (including sole proprietorships), debt financing and distributions should be taxed in the same manner as retained profits of a corporation. This is essentially the dual income approach under which individuals are taxable with respect to capital income at a single flat rate while their income from labour (or at least income from employment) is subject to taxation at progressive rates. This approach has been used in Scandinavian countries since the early 1990s.[489]

This approach suffers from a number of problems. First, and for many foremost, it is repugnant to the ability to pay principle. Second, it does not of itself suggest a particular rate of corporation tax, but the corporate tax rate is typically understood to be a rate that is substantially below the highest personal individual tax rate. Third, while it may resolve some of the interface issues discussed above, it opens up interface issues on other fronts. In particular, it opens up interface issues for the difference between sole proprietors and employment and encourages people to try to convert labour income into income from capital. Further, it does not resolve all of the usual interface issues. In particular, the distinction

[489] Griffith, Hines & Sørensen (2010) discusses the possibility of such an approach for the UK.

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between debt and equity remains an issue for exempt investors and, in particular, pension funds and non-residents.

Temporary Surrogate If corporation tax were to perform as a temporary surrogate for the personal income tax, what does that suggest for the corporate tax rate? What is the best rate to act as a surrogate? That depends on identifying the shareholders of the corporation in question. For the sake of simplicity, presume a corporation, A Co, with four shareholders, each holding a quarter of the shares in the corporation. Three of these shareholders are individuals, one with a tax rate of 40 per cent, one with a tax rate of 20 per cent and one who is exempt. The other shareholder is another corporation, B Co. Presume that B Co is taxable (for whatever reason) at 30 per cent. At what rate should A Co be taxed so that the taxation acts as an appropriate surrogate for the taxation of A Co's shareholders?

Some might suggest that A Co should be taxed at the same rate as B Co. That would be an appropriate surrogate for the taxation of B Co. However, the reason why many people might suggest this is not because that is the best rate to act as a surrogate, but because of a belief that two corporations should be taxed at the same rate. This has more to do with issues of competition than the temporary surrogate philosophy. In any case, 30 per cent is not an appropriate surrogate for any of the other shareholders, at least not individually.

Others might suggest that the most appropriate tax rate for A Co is 40 per cent, being the highest rate applicable to any of its shareholders. This position is taken by a number of countries and sometimes (increasingly infrequently) other countries go further by taxing corporations above the highest individual rate.[490] A reason for doing this is that if any rate less than 40 per cent is used, A Co may be used as a corporate tax shelter for the 40 per cent shareholder. Again, this approach focuses on one shareholder and may be considered inconsistent with the collective nature of corporations. Problems associated with fragmenting a corporation in this way according to particular shareholders were discussed above at 1.2.3.2 in the context of minority shareholders.

The temporary surrogate philosophy makes sense only if it is applied to the shareholders as a group, much in the way that corporate law often identifies a corporation with its shareholders as a group. The shareholders have invested on equal terms and will be expecting equal treatment,

[490] See Harris (2010, 580).

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at least until such time as profits are distributed. In other words, shareholders on lower rates would not expect their share of retained profits to be taxed at a lower rate than the share of shareholders on higher rates. They would expect retained profits to be taxed on a homogeneous basis that reflects the reality of those profits as an undivided pool. This suggests that the appropriate surrogate for personal taxation is the taxation of the shareholders as a whole, that is, the aggregate taxation of the shareholders.

This aggregate view of the shareholders might suggest that the corporate tax rate should be the average weighed tax rate of the corporation's shareholders as a group. This is an interesting suggestion because it creates some sense of (but not complete) neutrality in the main interfaces with the corporate tax rate. This is the rate that the shareholders as a group would face in aggregate if they conducted the corporate activities in partnership (assuming partnerships to be transparent). It is not the rate they would individually face in a partnership. It is only possible to achieve neutrality in that sense if the profits are disaggregated, that is, if the corporation is taxed on a transparent basis as discussed below at 1.3.3. The same comments can be made with respect to the distortion between debt and equity financing.

Using average weighed shareholder tax rates as a corporate tax rate creates a particular form of neutrality in the interface between retention and distribution. Directors tend to consider shareholders as a group, at least in the absence of controlling shareholders, and directors' duties tend to require them to do so. Viewing shareholders in this way, whether there is a tax incentive to retain or distribute is a simple question of whether in aggregate more or less tax will be levied when profits are retained or when they are distributed. If the corporate tax rate is the average of weighed shareholder tax rates, then in principle no more and no less tax will be levied on distribution when compared with retention.[491] This should provide some neutrality for directors in deciding whether or not to distribute corporate profits.[492]

At a general level, the temporary surrogate philosophy has some logic about it. That logic breaks down once the specifics of particular corporations are considered. The problem is that persons on different tax rates

[491] This presumes that in aggregate distributed profits would be taxed at shareholder regular rates, that is, taking into account both corporate-level tax and shareholder-level tax.

[492] See Kaserer, Rapp & Trinchera (2011, 21) and the discussion below at 2.3.2.3 for an observation that corporations managed by substantial shareholders might distribute more profits.

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invest in different corporations in different proportions. So, the average shareholder tax rate for one corporation may not be the same as for another corporation. Further, the average shareholder tax rate for a corporation at one point in time may not be the same as at another point in time. Shareholder tax rates may vary from year to year or shares in the corporation may be sold between persons on different tax rates.

At a practical level, it is not possible to have a custom tax rate for every corporation. Nevertheless, in the context of widely held corporations, at least listed corporations, it is possible to identify, and we often speak of an average shareholder tax rate. So, in the context of widely held corporations, it might be possible to target a corporate tax rate somewhere near the average shareholder tax rate. As corporations become closely held and control enters the picture, any such logic falls away.

If the corporate tax rate is below the highest individual rate, it can be expected that persons on the highest rate will band together and seek to shelter their income behind the corporate form. This results not only in individual benefits for each shareholder, but an aggregate benefit when compared to the average shareholder tax rate. Indeed, if corporations are taxed with respect to retained profits, then in the context of closely held corporations the only way in which to prevent corporations being used as tax shelters is to tax them at the highest individual rate.

By comparison, persons on tax rates below the corporate tax rate are discouraged from adopting the corporate form or at least retaining profits in a corporation, depending on the tax treatment of distributions. They are likely to seek transparent forms of taxation. There are a number of manners in which this might be achieved. They may use a transparent form of business, such as a sole proprietorship or partnership. They may seek a return from the corporation in a deductible form, such as through wages, royalties or interest. They may also seek distributions instead of retentions if these are taxed overall (corporate and shareholder-level taxes) more lightly.

The bottom line is that in the context of closely held corporations and progressive rates, the only manner in which to achieve any sense of neutrality between different forms of doing business, financing the business and retention or distribution is by treating the corporation as transparent. Some of these issues can be partly addressed with a flat tax on capital income, but as discussed above, that causes its own problems. Widely held corporations appear to raise different issues. However, distinguishing between widely held and closely held corporations is inherently problematic (see above at 1.1.5.2). There seems no way out of the circle.

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Competition It would be naive to suggest that any country today consciously seeks to follow the temporary surrogate philosophy to corporate taxation, although it may be subconsciously considered when grappling with the corporate tax shelter problem. What countries are increasingly attuned to is tax rate competition, particularly in economic blocks such as the EU. The last three decades have seen a dramatic drop in corporate tax rates around the globe, particularly in the last 20 years. The average corporate tax rate has dropped from 31.4 per cent in 1999 to less than 24 per cent in 2022. The drop has been particularly significant in the Asia, where the average is now less than 20 per cent, and in the EU where it is just over 21 per cent. It is far less dramatic, for example, in Africa and Latin America, where the average is over 27 per cent.[493]

Personal income tax rates have dropped over the same period, although not to the same extent. Further, personal income tax rates have stabilised in the last ten years. Especially in OECD countries, this has left a widening gap between the highest tax rate for individuals and the corporate tax rate. In 2021, the average corporate tax rate in OECD countries was 23 per cent, whereas the average highest individual tax rate (excluding social security contributions) was 42.5 per cent.[494] This is dramatically different from world averages of 24 per cent for corporate tax rate and 31 per cent for highest individual tax rate.[495] It means that developed countries typically have a massive corporate tax shelter problem because there is the potential to shelter income from on average nearly 20 per cent tax if income is derived and retained in a corporation. For other countries the problem is substantially less.

Interestingly, as corporate tax rates have fallen, the number of exempt entities and non-residents holding shares in widely held corporations has risen dramatically. Using UK quoted shares as an example; 50 years ago resident individuals held half of UK quoted shares. That figure has dropped by more than three quarters, that is, to 12 per cent. Initially, the

[493] See Tax Foundation, 'Corporate Tax Rates around the World, 2022', available at https://bit.ly/45iT6uo, accessed 15 June 2023.

[494] See OECD, 'Tax Database Key Tax Rate Indicators' (December 2022, 12–14), available at www.oecd.org/tax/tax-policy/tax-database-update-note.pdf, accessed 15 June 2023.

[495] See KPMG's *Individual Income Tax Rates Table* for various years, available at https://bit.ly/45lkvMd, accessed 15 June 2023. The last year available is 2020 and unfortunately it seems this table is no longer being updated. The average for 2022/23 seems to be broadly the same, see Trading Economics, 'List of Countries by Personal Income Tax Rate', available at https://bit.ly/3Q92AmD, accessed 15 June 2023 (countries with no personal income tax were discounted in calculating the average).

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drop was taken up by institutional investors and, in particular, pension funds. By the 1990s, resident institutional investors held more than half of quoted shares, with pension funds holding more than 30 per cent. Since this time, the proportion of quoted shares held by institutional investors has halved and there has been more than a threefold increase in shares held by non-residents. Non-residents now hold more than 56 per cent of UK quoted shares.[496]

Pension funds are typically exempt from income tax and this is commonly true of non-resident shareholders receiving dividends.[497] The result is that average shareholder tax rates, especially for widely held corporations, have dropped dramatically over the same period during which corporate tax rates have dropped. This may be no coincidence and while it can be suggested that the corporate tax rate has lowered so as to be a better surrogate for shareholder taxation, that is unlikely to be the primary reason for the coincidence. This is because corporation tax is typically not a temporary surrogate for shareholder taxation of non-residents and tax-exempts; it is a final tax.

Besides general competition for portfolio investors, a major factor at work in the lowering of corporate tax rates may be the distortion between the taxation of returns on equity compared to those on debt. A flow of funds in the form of interest going to tax-exempts and non-residents is typically untaxed at either the corporate level or the shareholder level by the country where the corporation is located. By contrast, a flow of funds in the form of dividends going to the same investors is likely to be taxed, but only at the corporate level, that is, by the corporation tax. The substitutability of debt and equity is likely to cause excessive reliance on debt and put downward pressure on the corporate tax rate.[498]

So, tax competition is felt most acutely in the context of widely held corporations. These corporations account for a massively disproportionate share of all corporation tax collected and are also held disproportionately by non-residents. However, as noted in the introduction, the overwhelming *number* of corporations are small, closely held

[496] Office for National Statistics (2010, 4) and Office for National Statistics (2022). It may be presumed that the volume of foreign shares held by resident institutional investors has increased dramatically in the past three decades.

[497] Regarding the taxation of non-resident shareholders receiving dividends from resident corporations, see below at 3.1.2.

[498] See Harris (2010).

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corporations, and these most commonly have no tax-exempt or non-resident shareholders. Here tax competition seems less relevant than for widely held corporations and the debt versus equity interface is likely to be less acute. By contrast, the corporate versus non-corporate interface and, particularly, the distribution versus retention interface are likely to be more acute. An increasing problem for governments is being able to distinguish between these two different types of corporations. As tax competition drives down corporate tax rates because of international factors, it drives up corporate tax shelter problems with the vast majority of corporations. The situation can be different if widely and closely held corporations are subject to different corporate tax treatment.[499]

1.3.2.2 Options in Selecting a Corporate Tax Rate

Considering the factors discussed above at 1.3.2.1, there are a multitude of manners in which a country can set a corporate tax rate. A majority of countries simply have one corporate tax rate. If multiple rates are used, these can be set in a number of manners. They might be set by reference to the amount of income derived (i.e. progression), the type of income derived (i.e. differentiation) or the variation may be caused by additional levies at regional level. Some countries apply a different rate to an alternate tax base to ensure that a minimum level of corporation tax is levied. Many countries had rules applying a higher corporate tax rate to undistributed profits in order to prevent unacceptable deferral of shareholder tax on dividends. The US still has such rules.

Main Rate The main issue with respect to the main corporate tax rate is how it compares to the highest tax rate for individuals. [500] For many years dating back to the 1980s, the highest US federal corporate tax rate was equal or close to the highest individual tax rate; often 35 per cent and 39.6 per cent, respectively. However, the Trump tax reforms of late 2017 reduced the corporate tax rate to 21 per cent while the highest rate for individuals was more modestly reduced to 37 per cent.[501] As a result, in recent years the US has had to face an increased corporate

[499] Liscow & Fox (2020) make a case for higher corporate tax rates arguing that recent changes mean that corporate tax law (at least in the US) is increasingly targeted at economic rents (which can bear higher levels of tax without harming economic activity) and changes in the US economy mean that corporations earn more economic rents.

[500] Foreign corporations can be a corporate tax shelter problem for all countries. Rules for controlled foreign corporations are briefly discussed below at 3.2.2.1.

[501] US corporate tax rate is found in IRC (US) s. 11 and individual tax rates are found in s. 1.

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tax shelter problem. Since the check-the-box regime was introduced from 1997 it has been common for individuals to elect to be taxed on a transparent basis when deriving income through an LLC. In many cases that situation is now reversed, with an increase in election to be taxed as a corporation and hence at the corporate tax rate with respect to retained profits.[502]

The choice to be taxed as a corporation because of the lower corporate tax rate is ameliorated in the case of individual business owners. The Trump reforms granted them a special deduction (based on wages paid with a potential capital element) that has the potential to reduce effective taxation of the business to a maximum of just below 30 per cent (which is a fair bit less than the corporate tax rate plus the highest dividend rate).[503] In addition to the federal corporate tax, US corporations are typically subject to State corporation taxes. The rates vary from State to State, ranging from nil to a maximum of 13 per cent, and the tax base is largely an apportionment of the federal corporation tax base.

Germany is also a federal country, but its municipal level trade tax is substantially more than the corporate taxes in US States. Germany imposes a federal corporate tax rate of 15 per cent, which is increased by a surcharge, making it 15.825 per cent.[504] Municipal trade tax is imposed by federal law largely on the same base as the federal corporate tax.[505] The trade tax is imposed at the rate of 3.5 per cent, but municipalities increase this by selecting a multiplier of between 200 per cent and 490 per cent. The result is a trade tax rate of typically around 14 per cent. The result is a combined corporate tax rate in the vicinity of 30 per cent. This is still substantially lower than the highest individual rate of 45 per cent, which is increased to approximately 47.5 per cent by the surcharge.[506] So there is some potential to use corporations as tax shelters in Germany. Trade tax would increase this distortion dramatically for individual traders. However, individual traders are given a lump sum credit against the income tax to offset the imposition of trade tax.[507]

By contrast, UK corporation tax involves no regional levy, only the imposition by the central government. As for income tax, the UK

[502] Regarding the impact of the rate reduction on choice of entity, see Repetti (2018).
[503] IRC (US) s. 199A. Regarding the complexity of predicting the effects of this provision, see Oei & Ring (2018).
[504] KStG (Germany) s. 23(1).
[505] Trade Tax Law (*Gewerbesteuergesetz*, GewStG) (Germany).
[506] EStG (Germany) s. 32a.
[507] EStG (Germany) s. 35.

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re-imposes corporation tax every year in the annual Finance Act.[508] For the tax year being 1 April 2023, the main corporate tax rate is 25 per cent.[509] Considering the current highest tax rate for individuals is 45 per cent,[510] the UK suffers a substantial corporate tax shelter problem. This is made worse for the difference in tax treatment of an individual trader compared to an incorporated business by the small profits rate discussed below. That discussion also considers the manner in which the UK has reacted to the problem.

In China, the main corporate tax rate is 25 per cent.[511] This leaves substantial scope for corporate tax shelter problems in China. The extent of the problem varies depending on the type of income in question; from a high of 20 per cent difference for income from labour and royalties (taxed at up to 45 per cent), to a disincentive to derive income through a corporation in the case of passive income (taxed at a flat rate of 20 per cent).

Progressive Rates If a country imposes corporation tax at progressive rates, it is very unlikely that it will use the individual progressive rate schedule in doing so. This is illustrated by China, which has a lower rate of 20 per cent for enterprises with low profits (taxable income not exceeding RMB 3 million, employees not exceeding 300 and assets not exceeding RMB 50 million).[512] Until end of 2027 this rate is effectively reduced further (through a reduction in taxable income) to 5 per cent for taxable income up to RMB 1 million.[513] The former US progressive corporate tax rates, which applied before 2018, also did not use the individual rate schedule.[514] Germany does not use progressive corporate tax rates.

The UK also imposes corporation tax at progressive rates, although between 2015 and 2022 it had a flat rate. Section 18A of CTA 2010 provides for the imposition of corporation tax at a 'small profits rate'. This rate is also set by the annual Finance Act. The small profits rate for the tax year beginning 1 April 2023 is 19 per cent.[515] The small profits rate only applies up to a threshold of £50,000. The benefit of the small profits rate is clawed

[508] CTA 2009 s. 2(1).
[509] Finance Act 2021 (UK) s. 6(2).
[510] Finance Act 2022 (UK) s. 2.
[511] EITL (China) Art. 4.
[512] EITL (China) Art. 28 and EITR (China) Art. 92.
[513] Circular of MOF & SAT [2023] No. 12.
[514] Regarding these progressive rates, see the first edition of this book.
[515] Finance Act 2021 (UK) s. 7.

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back by a statutory formula for profits between £50,000 and £250,000.[516] This formula is commonly understood to simply apply a higher rate to profits between these limits. At present the UK higher rate can be calculated as 26.5 per cent. This means that profits up to £50,000 are taxed at 19 per cent, between £50,000 and £250,000 at 26.5 per cent and above £250,000 at 25 per cent. This is dramatically different from the situation for individuals where the 40 per cent rate starts to apply around £50,000 of income and the 45 per cent rate at around £150,000.[517]

The distortions caused by this UK structure are substantial. If social security contributions are taken into account, individuals earning over £250,000 can more than halve their tax bill by deriving income through and retaining profits in a corporation. Even for those with income above £50,000 there can be substantial benefits from splitting income with a corporation, for example through a combination of wages and retained profits. Further, corporations also provide an opportunity to income split with family members, especially spouses.[518] In the result, it is largely for tax reasons that the UK has a disproportionately large number of small companies (see the introduction).

It is one thing to permit an individual to split income with a controlled corporation. It is quite another thing to permit individuals multiple income splits by using multiple corporations. Using China as an example, without income splitting rules, it would be possible for an individual to form a number of corporations in order to get the benefit of the low profits corporate tax rate many times over. This problem does not arise for countries that use a single flat corporate tax rate. Countries that use progressive rates for corporations usually have special rules that apportion the rate bands between corporations that are subject to common control. The UK has such rules. There are no anti-splitting rules in the case of China's low profits rate, although in an extreme case the general anti-avoidance rule may be triggered.

In the UK, the £50,000 and £250,000 small profits rate thresholds are divided evenly between 'associated companies'.[519] Confusingly, 'associated companies' is defined in section 18E(4) of CTA 2010 in very similar, though not identical, terms to the definition of 'associated company' in

[516] CTA 2010 (UK) s. 18D.

[517] ITA 2007 (UK) s. 10. There is an effective 60 per cent rate as the personal exemption is withdrawn between £100,000 and about £125,000; s. 35.

[518] Regarding income splitting using a family corporation in the UK, see Harris & Oliver (2008).

[519] CTA 2010 (UK) s. 18D(3).

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section 449 (considered above at 1.1.5.1).[520] Two corporations are associated if one is under the 'control' of the other or both are under the 'control of the same person or persons'. 'Control' takes its meaning from sections 450 and 451, which were considered above at 1.1.5.1. Generally, 50 per cent ownership will be sufficient. Section 18E(3) specifically excludes from associated a corporation that has not 'carried on a trade or business at any time in the accounting period';[521] presumably because it will be a 'close investment-holding company' and the headline rate will apply (see below).

The attribution of rights for the purpose of determining control under section 450 of CTA 2010 was also considered above at 1.1.5.1. In particular, rights held by 'associates' may be attributed to a person for the purposes of determining whether they have 'control' of two corporations. 'Associate' is defined by reference to section 448. In particular, an individual is an associate of a relative or a partner. This could have arbitrary results. It meant that a corporation owned by an individual was automatically associated with a corporation owned by the individual's children or remoter issue or siblings. The same applied to corporations owned by business partners. In all these cases the small profits rate thresholds had to be apportioned, irrespective of how independent the corporations were.[522] This situation was relieved in 2011, now by section 18G. Two corporations are associated only if there is 'substantial commercial interdependence' between them.[523]

Differentiation Corporate tax rates may vary depending on the type of activity that a corporation engages in. China has numerous examples, such as the 15 per cent corporate tax rate for 'important high-tech enterprises'.[524] This is an example of an incentive nature. The UK has

[520] The definition of 'associated companies' in CTA 2010 (UK) s. 18D is qualified by a number of rules in ss. 18F-18J, which deal with, amongst other things, association through preference shares, loans and trusts.

[521] In *RCC* v. *Salaried Persons Postal Loans Ltd* [2006] STC 1315 (Ch) it was held that a corporation that merely rented premises was not carrying on a business for the purposes of this rule.

[522] This was particularly a problem for large professional partnerships, where the partners did not know how many corporations their fellow partners owned. The result was, in effect, that the small profits rate was not available.

[523] The Corporation Tax Act 2010 (Factors Determining Substantial Commercial Interdependence) Regulations 2022 outlines the factors to be considered when determining whether there is substantial commercial interdependence.

[524] EITL (China) Art. 28.

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an exception of an anti-abuse nature. The UK's small profits rate is not available for a 'close investment-holding company' or a non-resident corporation.[525] 'Close investment-holding company' is a subset of 'close company'; 'close company' was discussed above at 1.1.5.2. A close investment-holding company is a close company that:

> exists wholly or mainly for … the purpose of carrying on a trade or trades on a commercial basis [or] for the purpose of making investments in land, or estates or interests in land, in cases where the land is, or is intended to be, let commercially…[526]

So, close investment-holding companies are taxed at the headline corporate tax rate on all of their profits. Originally, this was designed to prevent individuals sheltering passive investment income from higher rates of tax. As the main rate of corporation tax has reduced and the gap between the small profits rate and the main corporate tax rate has narrowed, the close investment-holding company regime has become pretty useless in deterring the use of corporations as tax shelters.

Anti-erosion: Alternative Minimum Tax Some countries are concerned that their standard corporation tax base incorporates too many concessions or at least concessions that might be over exploited. Beginning in 1970, the US introduced the alternative minimum tax to combat the over-use of concessions. Numerous other countries, though not a dramatic number, have enacted rules for a similar purpose including India.[527] They all serve the same purpose of seeking to prevent an over erosion of the corporation tax base.

Minimum tax rules vary substantially from country to country. They can be calculated as a percentage of turnover or assets. Notoriously, the US alternative minimum tax was calculated by comparing a 20 per cent tax applied to an altered tax base (excluding concessions) with corporation tax otherwise payable ('regular tax'). The excess of the 20 per cent tax over the regular tax was payable as alternative minimum tax. The alternative minimum tax for corporations was repealed in the 2017

[525] CTA 2010 s. 18A. Non-resident corporations were discussed above at 1.1.2.2. The UK tax administration accepts that the benefit of the small profits rate must be granted to a non-resident corporation if the corporation is resident in a country that has a tax treaty with the UK incorporating a non-discrimination provision.

[526] CTA 2010 (UK) s. 18N.

[527] See Income Tax Act, 1961 (India) s. 115JB. For other countries with an alternative minimum tax see https://bit.ly/3Q8Zos3, accessed 15 June 2023.

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Trump tax reforms.[528] However, certain elements of minimum tax reappeared in the form of the base erosion anti-abuse tax (BEAT) and the global intangible low-taxed income (GILTI) regime.[529]

Then from the start of 2023 the US corporate alternative minimum tax reappeared in a substantially altered form (in the same section of the IRC but without repealing BEAT or GILTI).[530] It is again calculated as the difference between 'tentative minimum tax' and regular tax, but the tentative tax is now calculated as 15 per cent of adjusted financial statement income. The strong relationship between this altered minimum tax and financial statements was discussed above at 1.2.1. As previously, a corporation that pays alternative minimum tax can carry it forward and set it against regular corporation tax liability of future years. However, the set-off cannot reduce regular corporation tax below the tentative minimum tax amount.[531] In this way, tentative minimum tax is averaged out and fluctuations between regular tax and tentative minimum tax over a number of years can settle at the overall tentative minimum tax amount.

Increasingly, countries will have a minimum tax in the form prescribed by the OECD for its global minimum tax. This was also discussed above at 1.2.1 and is beyond the scope of this book.

Anti-deferral: Tax on Excessive Retention Historically, when income tax rates were proportionate for both individuals and corporations, distortions as to incorporation, debt versus equity and, typically, retention versus distribution were not substantial. This changed dramatically with the introduction of progressive income tax for individuals, especially around the time of the First World War. The situation was aggravated when classical systems became popular in the 1930s and 40s.[532] In the face of high progressive tax rates for individuals, the result was a massive incentive to retain profits in a corporation, that is, the corporate tax shelter problem. As a result, many countries, including the UK and the US, introduced rules to prevent excessive retention by corporations, which was viewed as avoiding

[528] Regarding the former system and the purpose of the US alternative minimum tax, see Shaviro (2020) and the first edition of this book.

[529] IRC (US) ss. 59A and 951A(a), respectively.

[530] IRC (US) s. 55.

[531] IRC (US) s. 53.

[532] The classical system involves the taxation of corporate income when derived and the taxation of distributions without relief for one tax against the other. See below at 2.3.1.

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shareholder tax. Originally, these rules allocated undistributed profits of corporations to shareholders for the purposes of imposing progressive taxation (at rates above the corporate rate).[533] These rules were of a type discussed below at 1.3.3.

Concerned at the constitutionality of the allocation to shareholders, in 1920 the US moved instead to impose an additional tax on corporations retaining profits 'beyond the reasonable needs' of their business.[534] This is the origin of the US accumulated earnings tax. This tax remains despite the repeal of similar provisions in other countries and despite the 2017 Trump tax reforms. The severity of the US accumulated earnings tax was reduced as a result of the introduction of dividend relief in 2003 (see below at 2.4.3.2). Indeed, if the accumulated earnings tax is considered part of regular corporation tax, the US system looks much like dividend relief in the form of a split rate system, with a higher corporate tax on retained profits than on distributed profits. However, in form, it is an additional tax on retained profits (not a lower tax on distributed profits) and so it is appropriate to consider it at this point.

Section 531 of IRC imposes, in addition to other corporate taxes, a tax of 20 per cent on the 'accumulated taxable income' of corporations. As will be discussed at 2.4.3.2, this is equivalent to the highest rate of tax on dividends paid to resident individuals. Nevertheless, the accumulated earnings tax is a penalty tax; shareholders are still taxable on distributions without credit for any accumulated earnings tax paid with respect to the profits distributed. The tax is still couched in terms of corporations being used for the purpose of avoiding shareholder income tax on distributions.[535] In form, this imposition has no regard to whether the corporation is widely or closely held. In practice, however, the tax is rarely imposed on publicly held corporations due to difficulty in establishing a tax avoidance purpose.[536] If a corporation retains profits 'beyond the reasonable needs' of its business, the corporation is treated as having an avoidance purpose (unless it proves otherwise). Similarly, the fact that a corporation is a holding or investment corporation is prima facie evidence of the avoidance purpose.[537]

[533] See Harris (1996, 105 fn. 282) regarding the original rules in Australia, Canada, the UK and the US.
[534] Revenue Act of 1921 (US) s. 220.
[535] IRC (US) s. 532.
[536] See Bittker & Eustice (2003–, para. 7.02[1]) and the references cited therein.
[537] IRC (US) s. 533.

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'Accumulated taxable income' is taxable income (subject to certain adjustments) less dividends paid and a standard credit.[538] To be deductible, the dividends must be paid during the tax year in question or before the 15th day of the fourth month of the following tax year.[539] The credit is equal to profits retained for the reasonable needs of the corporation's business. There is an aggregate minimum credit of $250,000 ($150,000 for certain personal service corporations) accumulated from past and present profits.[540] This credit is apportioned equally between members of a 'controlled group of corporations'.[541]

Case law suggests that what is required to determine reasonable business needs is a comparison between a corporation's total liquid assets at the end of the year with its reasonable business needs.[542] The Treasury Regulations outline a number of acceptable grounds for reasonable business needs including business expansion and plant replacement, business acquisition, debt retirement and working capital. Not acceptable are loans to shareholders and related parties and investments in areas not related to business.[543] Most corporations avoid paying accumulated earnings tax by ensuring the distribution of sufficient profits.

The US replaces accumulated earnings tax with an equivalent tax for personal holding companies.[544] A 'personal holding company' is a closely held corporation and the definition of that phrase was considered above at 1.1.5.2. The main difference between accumulated earnings tax and the tax on personal holding companies is that the latter does not incorporate a credit for the reasonable needs of a corporation's business.

1.3.3 Taxing Owners and Controllers

When a corporation derives and retains profits, a country may decide to tax owners and controllers of the corporation with respect to those profits, either in substitution for or as a supplement to taxation of the corporation. In the present context, it is presumed that the corporation has been allocated the income, which has been calculated at the corporate level. Therefore, this section is not concerned with situations in which

[538] IRC (US) s. 535(a). Under (b)(1), a deduction is allowed for regular corporation tax.
[539] IRC (US) ss. 561 and 563.
[540] IRC (US) s. 535(c).
[541] IRC (US) s. 1561.
[542] See Bittker & Eustice (2003–, paras 7.03 to 7.06).
[543] Title 26 Code of Federal Regulations (US) § 1.537-2.
[544] IRC (US) s. 541.

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the corporation's identity is collapsed, such as for disregarded entities under the US check-the-box regime (see above at 1.1.4.2).[545] However, this section does consider some hybrid regimes under which the corporation retains its identity and calculates income for tax purposes, but under which some activities of the corporation are directly attributed to its owners and controllers.

There are a number of manners in which owners and controllers of a corporation may be attributed income as a result of and taxed with respect to retention by the corporation. There are limitations on the use of each option and so factors to consider in adopting an option. These are the first matters discussed in this section. The most common method of allocation is the partnership method, which is the second matter discussed in this section. Historically, corporate tax systems were generally concerned about the use of corporations as tax shelters. With increasing support for the idea that capital income should be taxed more lightly than income from labour (see above at 1.3.2.1), some countries have become more focused on the use of corporations to shelter income from personal services from tax. Attribution of personal services income derived through a corporation is the final matter considered, in section 1.3.3.3.

1.3.3.1 Factors and Options for Allocation

There are three primary options for taxing shareholders with respect to retained profits of their corporation. Each face different issues. Any of these may be used as a substitute or supplement for taxation of the corporation.

Partnership Method In the context of a realisation-based income tax, the partnership method is the primary method for taxing shareholders with respect to the retained profits of corporations. Profits are determined at the corporate level including according to the usual realisation basis of the income tax. The aggregate profits are then allocated amongst persons according to their respective interests in the corporation, for example, in proportion to shareholdings. This method raises a number of conceptual issues and is impractical in certain circumstances.[546]

A first problem is the manner in which the profits are attributed. Shareholders are allocated and taxed with respect to profits of a corporation

[545] If the identity of the corporation is collapsed, then the corporation has no income and all activities of the corporation are attributed to its owners and controllers.

[546] Generally, see Harris (1996, 110–12) and the references cited therein.

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before they are distributed. A risk is that profits will subsequently be distributed in a different manner to that in which they were attributed when the profits were derived. This could particularly happen in corporations that have a number of different classes of shares with different rights as to distributions. The result could be the unacceptable situation in which one shareholder pays tax on profits ultimately distributed to another shareholder. For this reason, attribution might be limited to corporations with one class of share, for example, as under the US S corporation regime (discussed below).

Another difficulty is that a shareholder cannot file a tax return until such time as the corporation has determined its profits and set an allocation. This may not be a problem where a single corporation is involved, but it can be unworkable where corporations hold shares in other corporations. Consider the scenario in which A Co holds shares in B Co, which holds shares in C Co and C Co holds shares in A Co. Allocation may be virtually impossible in such a case and even if the circular problem is resolved, long chains of corporations holding shares in other corporations might prevent timely filing of shareholder tax returns.

Further issues involve characterisation of the allocation. Shareholder income is typically dividends, and this income has a singular character. But a corporation may derive many types of income, for example, exempt income, capital gains, foreign income, etc. Should the allocation to shareholders follow the character of the various types of income derived by the corporation, or should the allocation have a homogeneous character like dividends? If different types of income are to be allocated to shareholders, in what manner should the different types be apportioned, for example, according to a discretionary or strictly proportionate rule?

Other timing issues arise if shares are transferred during a tax year. Should the corporate profits be allocated to the shareholder who holds shares at the end of the year, or proportionate to all shareholders who held shares during the year? The former may be open to manipulation, and the latter may be impossible in widely held corporations where shares change constantly. In some cases, it may be impossible to identify all the relevant former shareholders for purposes of apportionment. Other issues are caused by potential adjustments to corporate taxable income by the tax administration, potentially years after the allocation to shareholders is made. It is not practical to seek to find and make adjustments to the tax returns of all former shareholders, and yet it may be unfair to adjust the tax liabilities of current shareholders.

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All of these issues mean that the partnership method is usually only practical in the context of simply structured closely held corporations, of the type often called 'quasi-partnerships'. This is perhaps unsurprising. Part of the reason for the facilitation of registered companies in the UK in the 1840s was the difficulty in allocating liability between many and varied partners. Tax is just one form of liability.

A major difference (at least historically) between the registered company and the traditional partnership is the limited liability of the average shareholder. This raises the issue of what should happen if a corporation makes a loss instead of a profit. Should shareholders be allocated losses and deduct them in calculating tax due on other income? It seems somewhat strange to permit shareholders to deduct losses for which they cannot be directly liable. There is a direct analogy here with permitting parent corporations to deduct the losses of subsidiaries under consolidation or group relief (see above at 1.2.3.2). A sound approach is to permit shareholders to deduct losses to the extent of their cost base in the shares in question (see discussion of US S corporation regime below at 1.3.3.2). Of course, the same issue can arise in the context of limited partnerships.[547]

By Reference to Value of Shares The partnership method has its limitations, particularly with respect to widely held corporations. These limitations can be overcome by focusing on the value of the shares held in the corporation that is retaining profits. Valuing shares in widely held corporations can be straightforward, particularly if the shares are listed on a stock exchange. By comparison, valuing shares in closely held corporations can be particularly difficult and involve substantial compliance costs. Here there is a particular synergy between the partnership method and methods that use the value of shares as a reference point, that is, the former are more suited to closely held corporations and the latter more suited to widely held corporations. Focusing on using the value of shares as a reference point, there are two main methods by which the value of shares may be used in order to, at least indirectly, tax the retained profits of corporations.

The more targeted of these two methods is to tax shareholders on the increase in the value of their shares. The presumption is that the retention of profits by the corporation increases the value of shares in the

[547] Regarding limited liability and transparent taxation of various types of entity including limited partnerships, see Röder (2017).

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corporation and so taxing that increase over the span of a year indirectly taxes the retained profits of the corporation. The current scenario presumes only retained profits, but under this approach dividends would be taxed to the shareholder in the same manner as any other income.

Taxing increases in the value of shares does not produce the same results as the partnership method. The partnership method is usually constructed in a fashion that only taxes profits realised at the corporate level. This is not possible if increases in the value of shares are taxed. Shares may increase in value for all sorts of reasons that do not involve the realisation of profits. Share values take account of changes in prospects for making profits and so have the potential to reflect realised and unrealised gains and losses. Therefore, to tax shareholders on increases in the value of shares would fundamentally alter the scope of the income tax in this particular context, perhaps in a way that many would view as unacceptable. Nevertheless, there are examples of countries using this method in an international context, see below at 3.2.2.1.[548]

A more obscure method of using share values to tax shareholders with respect to retained profits is illustrated by the Netherlands. The Netherlands adopts a schedular approach to income taxation of individuals, categorising the income of individuals according to 'boxes'. Box III includes income from non-substantial shareholdings. Dividends from such shareholdings are not directly taxable. Rather, income from such shares is calculated as a fixed weighted notional yield (currently 6.17 per cent) applied to the average value of the shares in question for the year net of liabilities.[549] The resulting notional income is taxed at a flat rate of 32 per cent for 2023. There is a general Box III exemption of a capital amount of €57,000.[550] So far as retained profits are concerned, this tax is levied in addition to an ordinary corporation tax that is largely based on realisations.

Taxation under the Netherlands Box III is not really taxation of retained profits of a corporation, although it may produce that effect. Rather, in substance it is simply the replacement of taxation of income

[548] Many countries tax at least some types of financial instruments on a mark to market (fair value) basis. For example, the UK does this with respect to foreign currency instruments. Generally, see Arnold, Ault & Cooper (2019, 419–24). In this context, taxing shares in the manner referred to in the text might produce consistency with at least some other types of financial instruments.

[549] Income Tax Law (*Wet op de inkomstenbelasting*) (Netherlands) s. 5.2.

[550] Income Tax Law (*Wet op de inkomstenbelasting*) (Netherlands) ss. 2.13 and 5.5, respectively.

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from shares with taxation of the capital value of shares. This is most clearly demonstrated in loss years when, despite a fall in value in the shares, shareholders are still taxed in a positive amount, that is, a set percentage of the reduced value of the shares. This Netherlands system has been in place for more than 20 years (it had an early predecessor dating back to the 1890s). However, at the end of 2021 the Dutch Supreme Court ruled that that Box III violates fundamental rights of taxpayers. This was followed with a plan to transition Box III into taxation based on actual income from 2026.[551]

The Netherlands system is, at some level, diametrically opposed to an exemption for a standard rate of return at the shareholder level, for example, as used in Norway.[552] Instead of taxing economic rents, the Netherlands Box III only taxes (at the shareholder level) a standard rate of return. Both these systems of shareholder taxation were introduced as a modernisation of traditional income taxation in order to deal with issues faced from a globalising world. The fact that they produce opposite results demonstrates continuing uncertainty and controversy over the best way to address the taxation of corporate income.

Capital Gains with Deferral Charge The taxation of shareholders with respect to an annual increase in the value of their shares as a method of taxing retained profits of a corporation is objectionable on the basis that it involves the taxation of unrealised gains. This objection can be removed by simply taxing gains on the disposal of shares (dividends would also be taxable). Taxing such gains is unobjectionable even if it involves taxing unrealised gains of the corporation because it does involve taxing a realised gain of the shareholder. However, waiting until a shareholder sells shares before taxing retained corporate profits would involve an unacceptable deferral of taxation and increase the corporate tax shelter problem. This deferral can be addressed by incorporating an interest charge for deferred tax on gains on the disposal of shares. The interest charge is best demonstrated with an example.

Presume that a shareholder holds shares in A Co for five years and makes a gain of 100 on the sale of the shares. This gain must be apportioned over the five years of ownership. This may be done on a simple time

551 Paez (2022).

552 Norway does this by providing an exemption for a standard rate of return on shares referred to as the shielding allowance (*skjermingsfradrag*); Income and Capital Tax Law (*Lov om skatt av formue og inntekt*) (Norway) Art. 10–12.

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apportionment basis, but to be more accurate, maybe this should be done on the basis of the average value of the shares during each year. Presume that the apportionment is simply a gain of 20 for each of the five years. Tax payable by the shareholder on each part of the gain would then be worked out for each of the five years. The tax for the first year of holding would be subject to a compound interest charge for the deferral of that tax in years two, three, four and five. The tax attributable to the second year of holding would be subject to a compound interest charge for years three, four and five, and so on. The interest charge is intended to remove the benefit of deferral and, therefore, the corporate tax shelter benefit.

Initially, it might seem that to impose a large tax on the gain and, in addition, to impose what might be a substantial interest charge would increase the lock-in effect of the realisation basis income tax. That is, it might be thought that shareholders would not sell their shares because they don't want to incur the tax and the interest. It is often countered that a rational shareholder would understand that there is no point in delaying disposal as the interest charge will increase the longer the shares are held. This may well be, but it is not clear that all shareholders would be so rational. Many may go on holding shares in the hope of avoiding the tax, for example as a result of reform, by moving overseas or on death. In any case, the capital gains with interest charge approach is not used as a basic approach in any major economy. The US does use this approach with respect to passive foreign investments, discussed below at 3.2.2.1.

1.3.3.2 Partnership Method

The 'partnership method' of allocating corporate profits to shareholders irrespective of distribution is so named because it is similar to the manner in which many countries allocate income derived through partnerships. There are two basic approaches to transparent partnership taxation that mirror the pure and partial consolidation approaches for group loss relief discussed above at 1.2.3.2. In the context of partnerships, these are often called the 'fractional interest' approach and the 'joint' approach. Like pure consolidation, under the fractional interest approach the partnership is purely transparent and does not derive income; the partners are considered to have a fractional interest in partnership assets and everything the partnership does. Under the joint approach, income is calculated jointly at the partnership level (typically there is a partnership tax return) and then allocated to the partners. It is this second, joint approach that is in focus here.

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The US applies the joint approach to partnerships.[553] As discussed above at 1.1.4.2, a group of persons holding a business entity such as an LLC that elects for transparent treatment of the entity (i.e. to not be treated as an 'association') is treated as a partnership for US tax purposes. In this case the normal partnership rules, including the joint approach, apply.[554] This is not a book about partnership taxation, and so these US rules are not considered further, despite the potential application to something that, with a different election, would have been considered a corporation.

However, the US has another regime, competing with the check-the-box regime, that involves the partnership method of allocating corporate profits to shareholders irrespective of distribution.[555] This is the S corporation regime, which only applies to something that is considered a corporation for US tax purposes. The S corporation regime was introduced in 1958 to provide greater neutrality between the taxation of small corporations and that of unincorporated businesses. There was a particular bias against the use of corporations during the years when the US adopted a full classical system, that is, full economic double taxation of corporate profits in the hands of corporations and dividends in the hands of shareholders (see below at 2.3.1). The S corporation regime has always been popular, but not a complete solution to the distortions of the classical system, as demonstrated by the proliferation of LLCs from the 1980s, introduction of the check-the-box regime from 1997 and the introduction of dividend relief in the US in 2003. Despite those reforms, the S corporation regime remains popular.[556]

The definition of 'small business corporation' was considered above at 1.1.5.2. As noted at that point, a small business corporation must not have more than 100 shareholders, who in principle must be individuals and residents, and must not have more than one class of stock. Corporations meeting these requirements may elect to be an S corporation. The election

[553] See IRC (US) Subchapter K and, particularly, s. 702. The UK also applies the joint approach to income of partnerships, but the fractional interest approach to capital gains; see Constable (2020).

[554] Title 26 Code of Federal Regulations (US) § 301.7701-3(a).

[555] Regarding differences in allocation rules under various US transparency rules including the partnership rules and the S corporation rules, see Taylor (2016, 3).

[556] In 2019, there were 5.1 million S corporations, 74 per cent of the total number of corporations. By contrast, there were 2.7 million LLCs treated as partnerships, making up 71.5 per cent of partnerships. Internal Revenue Service, 'Statistics of Income – Corporation Income Tax Returns Complete Report 2019' Publication 16 (Rev. 6-2022) and 'Statistics of Income – Partnership Returns, 2019' Publication 5338 (Rev. 6-2022), available at www.irs.gov/statistics/soi-tax-stats-business-tax-statistics, accessed 15 June 2023.

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and termination of election are freely available, but once terminated a new election cannot be made for five years from the date of termination unless the tax administration approves.[557] As a consequence of the election, an S corporation is not subject to corporation tax. The S corporation still has to calculate its taxable income but does so in the same manner as an individual. This means that, in principle, any elections that affect the calculation of the tax base are made by the S corporation.[558]

Shareholders must include in their taxable income their 'pro rata share' of the corporation's taxable income. Determining 'pro rata share' is simplified by the fact that an S corporation can have only one class of share.[559] Generally, it is the pool of corporate income that is allocated in this way. However, if separate parts of the income might affect the tax liability of a particular shareholder, those parts are allocated separately. The character of any amount included in a shareholder's share is the same as it is in the hands of the corporation. So, for example, the allocated share of a capital gain, dividend or foreign income of the corporation retains that character when allocated to the shareholder.[560] Importantly, this attribution occurs irrespective of distribution. If the share ownership changes during the year, income is generally prorated over the entire year and attributed to the shareholders before and after the change on a time basis.[561] This is workable because an S corporation can have no more than 100 shareholders.

Attribution of income of an S corporation to its shareholders results in adjustments to the cost base of shares held in the corporation. The attribution increases the shareholder's cost base as if the income had been distributed and then reinvested in the corporation.[562] This prevents the risk of double taxation of the shareholder with respect to the same economic gain, discussed below at 5.1.2. Section 1363 of IRC passes losses through to shareholders. These reduce the cost basis of the shares.[563] However, a shareholder's loss is limited to the total of the cost basis in the shares held and any debt the corporation owes to the shareholder. Any disallowed loss

[557] IRC (US) s. 1362(g).
[558] IRC (US) s. 1363.
[559] See Borden & Freudenberg (2019) regarding complexities and integrity issues in allocating distributions and capital contributions between members in a transparency regime. At 354 they note that 'the S Corporation, with only one class of membership interest, has fewer integrity rules governing allocations'.
[560] IRC (US) s. 1366(a) and (b).
[561] IRC (US) s. 1377(a) defining 'pro rata share'.
[562] IRC (US) s. 1367(a)(1). Distributions reduce the cost base of the shares.
[563] IRC (US) s. 1367(a)(2).

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may be carried forward until there is further investment in the corporation, for example, by additional capital contribution or by the recognition of corporate-level income.[564]

1.3.3.3 Personal Services Income

General regimes, such as the US's S corporation regime, may resolve the corporate tax shelter problem. This is the particular problem of an individual splitting income with a corporation, that is, causing the corporation to derive income that might otherwise have been derived by the individual. However, a general regime like this won't necessarily solve a basic income splitting problem, such as the splitting of income between two spouses. Income splitting between spouses (or other relatives) may be achieved directly, but corporations can facilitate income splitting indirectly. Not only may a controlled corporation employ a spouse, but the spouse may also be issued shares in the corporation and so be entitled to a share of corporate profits. An attribution regime such as the S corporation regime does not alter an income shift achieved in this way. Without more, it will allocate income to both spouses (because they both hold shares) irrespective of comparative contributions to the corporation.

Generally, income splitting may be addressed by selecting the family as the tax unit. If the individual is the tax unit, income splitting can also be addressed by case law, such as the assignment of income doctrine in the US, or, alternatively, a country might have a general anti-income splitting rule, such as in Canada and the UK.[565] These rules commonly accept that income from an outright transfer of assets from one spouse to another spouse is effective in transferring income for tax purposes. What is not accepted is that contractual arrangements can transfer income from personal services from one person to a related person, that is, income from personal services is inalienable (unlike income from assets). However, use of a corporation may circumvent this inalienability. In the absence of effective transfer pricing rules between an individual and a controlled

[564] IRC (US) s. 1366(d)(1).

[565] Generally, see Arnold, Ault & Cooper (2019, 437–42). The US case law follows *Lucas* v. *Earl* (1930) 281 US 111 (SC). Income Tax Act (Canada) s. 120.4 is a general rule to prevent income splitting between spouses or between individuals and related minors by way of 'transfer of property'. In 2018 it was expanded to cover the use of corporations to split income between family members. Similarly, the UK settlement rules may prevent income splitting but appear to be narrower; ITTOIA 2005 (UK) Part 5 Chapter 5. China and Germany have no specific statutory provisions. However, Germany has extensive case law, which is discussed in Arnold, Ault & Cooper.

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corporation (see above at 1.2.2), an individual may work for the corporation at below market value. This would make the corporation more profitable, and those profits (attributable to the individual's personal services) may be distributed to a spouse or other relative that holds shares in the corporation.[566]

Therefore, personal services corporations pose two types of problems for governments. One is the incentive to derive income and retain it in the corporation in order to avoid higher levels of individual taxation. The second is the ability to use a corporation to split personal services income between related parties in a way that would not be accepted if a direct income split were attempted. A general attribution regime such as the S corporation regime may address the first problem but requires more to address the second. Most countries have partially addressed the second problem by denying a deduction for excessive wages paid to related parties.[567] Some countries have attempted to address both problems in the context of a regime specifically targeted at the provision of personal services through a corporation or other intermediary. Some examples will illustrate the difficulties.

In the US, due to the check-the-box regime, an individual seeking to derive personal services income through a corporation (or LLC) may be subject to one of three regimes, each of which has special rules of relevance to the current discussion. With respect to the regular corporate tax regime (C corporation), historically the US had rules that taxed personal service corporations at the highest progressive corporate tax rate.[568] However, this system was abolished when the Trump tax reforms of late 2017 reduced the corporate tax rate to a flat 21 per cent. After this, the only provision left to protect sheltering and splitting personal services income through a corporation is a dedicated provision dating back to 1982. It provides that if 'substantially all of the services of a personal service corporation are performed for (or on behalf of) one other' entity and the corporation was formed to avoid income tax of an 'employee-owner', then income can be reallocated to the owner.[569] This provision has serious limitations, particularly the requirement that the services be provided to 'one' other entity.

[566] For a classic example of such an arrangement, see *Jones* v. *Garnett* [2007] UKHL 35 (HL). Generally, see Harris & Oliver (2008).

[567] For example, see IRC (US) s. 162(a)(1) and related regulations.

[568] Regarding these rules see the first edition of this book.

[569] IRC (US) s. 269A(a). A personal service corporation is one with a 'principal activity' of 'personal services … substantially performed by employee-owners'. Holdings of related parties are attributed to the taxpayer for purposes of this rule; IRC (US) s. 318.

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The second option is that the corporation is a corporation for US tax purposes, but an election is made for the S corporation regime to apply. Attribution under the US's S corporation regime is supplemented with a special rule targeted at reallocating attributions between family members. Section 1366(e) of IRC provides:

> If an individual who is a member of the family … of one or more shareholders of an S corporation renders services for the corporation or furnishes capital to the corporation without receiving reasonable compensation therefore, the Secretary shall make such adjustments in the items taken into account by such individual and such shareholders as may be necessary in order to reflect the value of such services or capital.

This is effectively a transfer pricing rule targeted at preventing income splitting of remuneration for personal services between family members through the use of S corporations.[570]

The third possibility in the US is that the corporation (presumed to be an LLC) is treated as transparent under the check-the-box regime. Here it is presumed that multiple members of a family are members of the corporation in an effort to income split. So, transparency will result in application of the partnership rules. This will generally mean that, unlike members of an S corporation, the members of the LLC cannot be employees of the LLC for tax purposes. Instead, a member's (partner's) entire share of income from the LLC (including 'wages') is treated as income from self-employment and subject to taxes as such (attributions from an S corporation are not subject to an equivalent).[571] Added to this complex cocktail is the special deduction for business income (discussed above at 1.3.2.2) which may apply to the entire attribution from an LLC (including any 'wages' part), but not the 'wages' paid by an S corporation.[572] The result in the US is a messy interplay of inconsistent rules.

The UK rules apply where an individual personally performs services for another person (the 'client') through a corporation (or other third party) and 'if the services were provided … directly … the worker would be

[570] Generally, see Bittker & Eustice (2003–, para. 6.05[6]) and the references cited therein. Historically, owners would understate wages received from an S corporation in order to minimise (higher) employment taxes. This is now more complex because the deduction under IRC (US) s. 199A (effectively a reduced tax rate for business income) is largely based on the payment of wages. See Burke (2019, especially at 581–82) and Burke (2021).

[571] IRC (US) s. 1402(a). See Burke (2019, 557) and Borden & Freudenberg (2019, 410).

[572] However, firms of service providers are excluded from the benefits by IRC (US) s. 199A(d)(1).

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regarded ... as an employee of the client.'[573] This rule is peculiarly narrow in being limited to a hypothetical employment scenario. It therefore incorporates all the difficulties of determining whether or not a person is an employee and seeks to apply those tests in the context of a hypothetical.[574] These rules were particularly concerned with the outsourcing phenomenon,[575] and the risk that this poses to the yield of the wage withholding tax.[576]

Recent debate in the UK has focused on who applies the obscure hypothetical test, the service provider or the service recipient. After thrusting the assessment and withholding on public sector service recipients in 2017, the assessment of the hypothetical test and withholding has been extended to medium and large private-sector service recipients from 2021.[577] The strategy seems to be that the service recipient is more likely to assess that the hypothetical test is met, increasing tension between service providers and service recipients.

This can be contrasted with the Australian rules, which rather adopt a broad rule and then specify exceptions.[578] These rules provide that an

[573] ITEPA 2003 (UK) ss. 49(1) and 61M(1).

[574] For examples of UK courts grappling with this issue, see *Usetech Ltd* v. *Young (HMIT)* [2004] STC 1671 (Ch) and *Dragonfly Consultancy Ltd* v. *RCC* [2008] EWHC 2113 (Ch). Recent high-profile cases have involved television presenters; for example, *Christa Ackroyd Media Ltd* v. *RCC* [2019] UKUT 326 (TCC) and *RCC* v. *Atholl House Productions Ltd* [2022] EWCA Civ 501 (CA). And see *Kickabout Productions Ltd* v. *RCC* [2022] EWCA Civ 502 (CA). For an assessment of the case law see Wilson (2018). The starting point for assessment of whether an individual is an employee is the three factor test (personal service, control and mutuality of obligations) of Mackenna J in *Ready Mixed Concrete* v. *Minister of Pensions and National Insurance* [1968] 2 QB 497 at 515, regarding which see Francis (2020). In *The Independent Workers Union of Great Britain* v. *The Central Arbitration Committee* [2021] EWCA Civ 952 (CA) the Court of Appeal found that Deliveroo riders were self-employed largely due to an ability to use substitutes.

[575] Employers seek to avoid strict laws on employees' rights by transferring former employees to independent agencies and requiring the employees to provide their services through a corporation. The former employees then seek to access the potential tax benefits associated with the new structure. For an example of this in the UK where the Court of Appeal held the individual was still an employee, see *Muscat* v. *Cable & Wireless plc* [2006] EWCA Civ 220 (CA).

[576] The wage withholding tax is typically the most significant proportion of income taxation. For example, in the UK for 2022/23 it accounted for about 85 per cent of all income tax receipts (exclusive of corporation tax) or nearly 27 per cent of all tax receipts. See HMRC, 'HMRC tax receipts and National Insurance contributions for the UK', available at https://bit.ly/3Q7KHWo, accessed 15 June 2023. In Germany, wage withholding also accounts for over 26 per cent of tax receipts; Arnold, Ault & Cooper (2019, 100).

[577] See ITEPA 2003 (UK) Part 2 Chapter 10.

[578] The Australian tax administration is in the process of replacing its guidance on the application of these rules; see Draft Ruling TR 2021/D2, available at https://bit.ly/3QakW7M, accessed 15 June 2023.

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individual must include in taxable income any 'personal services income' that another entity (a 'personal services entity') gains from the individual's personal services.[579] 'Personal services income' is defined by reference to income that is 'mainly a reward for your personal efforts or skills'.[580] The rules do not apply where the corporation conducts a personal services business or promptly pays wages.[581]

In outline, the 'personal services business' test is met if 75 per cent of the personal services income is for producing a result, tools are not supplied by the services acquirer and the corporation or services provider is liable for rectification of defects.[582] There is also a personal services business where the corporation has two or more clients that are not associated with the corporation as a result of general advertising. Alternatively, the corporation must have independent employees that perform at least 20 per cent of the work of the corporation. The test can also be met by the corporation having an independent and exclusive business premises.[583]

Where the UK rules apply, the service provider may be treated as receiving a payment from the corporation as employment income.[584] This is important because it means that wage withholding and National Insurance Contributions apply to the deemed payment. The service provider or an associate must have a 'material interest' in the corporation; defined as 5 per cent of ordinary share capital.[585] The amount of the deemed payment can be as much as 95 per cent of the payments made by the client to the corporation.[586] The corporation itself is not treated as transparent. It still has profits, and those profits are still liable to corporation tax. Rather, items in the calculation of those profits, that is, payments received from the client, are treated as having been on-paid to the individual as (deductible) wages. The Australian regime operates similarly, although more expressly.[587]

[579] Income Tax Assessment Act 1997 (Australia) s. 86-15(1).
[580] Income Tax Assessment Act 1997 (Australia) s. 84-5(1).
[581] Income Tax Assessment Act 1997 (Australia) s. 86-15(3) and (4).
[582] These factors are similar to those used by many countries in determining whether an individual is an employee.
[583] Income Tax Assessment Act 1997 (Australia) Division 87.
[584] ITEPA 2003 (UK) s. 50(1).
[585] ITEPA 2003 (UK) s. 51. 'Associate' is defined in s. 60 by reference to CTA 2010 (UK) s. 448, as to which, see above at 1.1.5.1.
[586] ITEPA 2003 (UK) s. 54.
[587] Income Tax Assessment Act 1997 (Australia) s. 86-30 effectively reduces the corporation's income by the amount attributed to the service provider.

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Tax planners soon found ways to circumvent these UK rules. In particular, unrelated service providers grouped together in a single corporation controlled and managed by a professional, typically a tax adviser. This 'managed service company' structure is now subject to separate anti-abuse rules, discussed below at 2.2.1.4. With such a substantial gap between the taxation of employment income and the taxation of income derived through a corporation, the UK's difficulties seem certain to continue. By contrast, the UK government seems to have no appetite for dealing with the use of corporations to shelter other types of income from higher progressive tax rates. The result is a form of indirect differentiation by which individuals with employment income are subject to greater taxation than other types of income.

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