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978-1-107-03349-8 - The Taxation of Corporate Groups under Consolidation: An International Comparison

Antony Ting

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PART I

The enterprise doctrine: theory and practice

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The rise of corporate groups: a challenge to the tax law

Income tax law in general treats a company as a separate taxable unit. This policy reflects the traditional separate entity doctrine under which a company is regarded as a separate legal entity from its shareholders. The rise of corporate groups in the last century poses a serious challenge to the doctrine. A corporate group under the common control of a parent company operates in substance as a single enterprise. How should the tax law respond to the tension between the legal doctrine of separate entity and the economic substance of a corporate group? A tax consolidation regime is an increasingly common response of the tax law to the changing paradigm, representing an application of the enterprise doctrine under which a corporate group is treated as a single taxable unit.

This chapter first provides an overview of the rise of corporate groups which challenges the traditional separate entity doctrine. It then describes the development of tax consolidation regimes as a comprehensive response of the tax law to the challenge. The chapter then explains the purpose and analytical approach of this book. It concludes with the structure of this book and a summary of the ensuing chapters.

1.1 The rise of corporate groups

Corporate groups are very significant and influential players in the modern commercial world. Many businesses, especially large and multinational enterprises, are conducted not by a single company but by a corporate group under the common control of a parent company. A report prepared by the United Nations showed that the sales of the top 200 multinational firms accounted for 27.5 per cent of world gross domestic product (“GDP”) in 1999.¹ Of the 50 largest “economies”, 14 were multinational corporate

¹ United Nations, *World Investment Report 2002: Transnational Corporations and Export Competitiveness* (2002, United Nations, New York), at 90. The sizes of multinational groups have been growing ever since: see for example, United Nations, *World Investment Report 2008: Transnational Corporations and the Infrastructure Challenge* (2008, United

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groups and 36 were countries. Furthermore, the sizes of multinational corporate groups have been growing at rates exceeding those of many economies. For example, the sales of the 500 largest firms in the world nearly tripled between 1990 and 2001, while the world GDP increased only 1.5 times in the same period.

Corporate group structures are very popular. For instance, an empirical study in Australia found that nearly 90 per cent of the top 500 listed companies (by market capitalisation) had at least one controlled entity.² Corporate group structures can be complex too. On average, each listed company had 28 controlled entities,³ 90 per cent of which were wholly owned subsidiaries. In fact, it is not uncommon for corporate groups to have a large number of subsidiaries and multiple levels of ownerships. A survey in 2010 found that the top 150 listed companies in Australia have an average of 62 subsidiaries.⁴

Why have corporate groups become more common in the modern business world? Several reasons have been commonly put forward. First, limited liability of a company shields, subject to exceptions where the corporate veil is lifted, the assets of a parent company from claims by the creditors of its subsidiary. Second, subsidiaries incorporated in tax havens may be used to shield profits of a corporate group from the reach of tax authorities in the home countries of the parent company and other fellow subsidiaries. For example, an empirical study shows that about 1.4 per cent of controlled entities of the top 50 listed companies in Australia were incorporated in three well-known tax havens: the British Virgin Islands, Cayman Islands and Bermuda.⁵ Third, it is common and convenient to structure the acquisition of a business in the form of shareholdings in a new investment vehicle, usually a company.

Nations, New York), at 26–29. The World Investment Reports are available at www.un.org.

² Ian M. Ramsay and G. Stapledon, “Corporate Groups in Australia” (2001) 29(1) *Australian Business Law Review* 7, at 8.

³ The average increased slightly to 30 in another empirical research in 2010: Sandra van der Laan and Graeme Dean, “Corporate Groups in Australia: State of Play” (2010) 20(2) *Australian Accounting Review*, 121, at footnote 16.

⁴ *Ibid.*, at 127. In both empirical studies, News Corporation came top with the largest number of subsidiaries: 778 in 2001 and 1,398 in 2010.

⁵ Ramsay and Stapledon, above note 2.

1.2 Tension between traditional legal principle and commercial reality

Corporation law evolved from a world where corporate groups did not exist. Before the nineteenth century, companies were formed under charter with individuals as shareholders. Corporate structures involved only two levels: individual shareholders and their companies. This was the time when the separate entity doctrine – under which a company is treated as a separate entity – was developed.

The rise of corporate groups poses a serious challenge to the traditional separate entity doctrine. The economic substance of a corporate group creates tensions between the separate entity doctrine and commercial reality. A corporate group under the common control of a parent company often operates as a single economic enterprise. In practice, senior management of a corporate group, and creditors dealing with companies within the group, often focus on the group as a whole instead of on individual companies. This raises the question of whether the law should recognise the commercial reality and extend the rights and duties of a company within a group to reflect the activities of other group members.

The modern commercial world dictates a change of paradigm with respect to the treatment of corporate groups. Instead of a universal adoption of the separate entity principle, a growing number of areas in taxation law are being supplemented by the enterprise doctrine. The enterprise doctrine focuses on the business enterprise as a whole, instead of its fragmented components. Under this doctrine, the economic substance overrides the legal form of individual companies that make up the corporate groups.

1.3 Tax consolidation: a response to the rise of corporate groups

In general, tax law adopts the separate entity doctrine and treats a company as a separate taxpayer. How should the tax law respond to the changing paradigm imposed by the rise of corporate groups? So far, the responses have been ad hoc and inconsistent. The different group taxation regimes in the world represent a spectrum of varying degrees of application of the enterprise doctrine, ranging from the relatively restrictive group loss relief regimes to the more comprehensive consolidation regimes.

In this book, the term “consolidation” refers to a full consolidation regime under which a group of resident companies is in general treated

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Table 1.1 *Years of introduction of consolidation regimes*

Year of introduction	Country
1917	United States
1940	Netherlands
1971	France
1977	Spain
1992	New Zealand
2002	Japan
2002	Australia
2004	Italy
2010	South Korea

as one single taxpayer and files a consolidated tax return, allowing *both* intra-group loss offsets and tax free asset transfers. The term “consolidation” may mean different types of regimes in different contexts. It may be used to include other group taxation regimes, such as the group loss relief in the UK and *Organschaft* in Germany.⁶ The term “consolidation” has even been used to cover virtually all forms of group taxation regimes.⁷

Consolidation is an increasingly common response of the tax law to the rise of corporate groups. The introduction of a consolidation regime is often a major tax reform of the income tax system in a country, fundamentally changing the taxation of corporate groups. Consolidation regimes are likely to become more popular for a number of reasons. First, the international trend shows an increasing number of countries adopting consolidation in recent years, as depicted in Table 1.1 above. While some countries have had a consolidation regime for many decades – namely, the US (1917), the Netherlands (1940), France (1971) and Spain (1977) – five countries have adopted a consolidation regime in the past two decades, namely New Zealand (1992), Australia and Japan (2002), Italy (2004) and South Korea (2010).⁸ As more countries

⁶ See for example the broader definition of “consolidation” in Tony Stolarek, “The Tax Treatment of Consolidated Groups: Managing Major Tax Change” in Chris Evans and Richard Krever (eds.), *Australian Business Tax Reform in Retrospect and Prospect* (2009, Thomson Reuters, Sydney), footnote 10 at 204.

⁷ For example, see Ernst & Young, *Barometer of Tax Competitiveness for 2009* (available at www.ey.com), accessed on 28 May 2010.

⁸ More countries are considering the introduction of a consolidation regime. For example, the Canadian government announced in its 2010 Budget that it would consider, among

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introduce consolidation regimes in their tax systems, other countries tend to be under more pressure – especially with the lobbying effort of businesses – to follow suit. In fact, many countries have introduced a consolidation regime to promote this policy objective. For example, all of the three most recent consolidation regimes – namely, in Italy, Japan and South Korea – were introduced with a clear objective to promote competitiveness.⁹ Second, two countries – namely Australia and New Zealand – introduced a consolidation regime, despite already having a group loss relief regime. For instance, Australia introduced its consolidation regime in 2002 largely to *replace* the existing regimes for intra-group loss offset and asset transfers partly due to the complexity arising from those existing group taxation regimes. It is reasonable to expect that some countries already equipped with other group taxation regimes may decide to introduce a consolidation regime.

1.4 The purpose, analytical approach and content of this book

This book provides, to the author's knowledge, the first comprehensive comparative analysis of the consolidation regimes in eight countries: Australia, France, Italy, Japan, the Netherlands, New Zealand, Spain and the United States. They are the eight countries that, by the end of 2009, have introduced consolidation regimes in their income tax systems.¹⁰

other things, the introduction of a consolidation regime: Minister of Finance, *Budget 2010: Leading the Way on Jobs and Growth* (available at www.fin.gc.ca), at 386, accessed on 5 April 2010. This was followed by the release of a consultation paper in November 2010: Department of Finance, *The Taxation of Corporate Groups* ("The Consultation Paper") (available at www.fin.gc.ca), accessed on 10 December 2010. It has also been reported that India is considering the introduction of a consolidation regime: IBFD, "Direct Taxes Code Bill, 2009 – Parliamentary Standing Committee submits its recommendations" (dated 15 March 2012) *IBFD Tax News* (available at www.ibfd.org), accessed on 19 April 2012.

⁹ Massimo Giaconia, "Branch Report: Italy" in International Fiscal Association, *Cahiers de Droit Fiscal International Volume 89b: Group Taxation* (2004), at 388; Fumihiro Komamiya, "Branch Report: Japan" in International Fiscal Association, *Cahiers de Droit Fiscal International Volume 89b: Group Taxation* (2004), at 393; and KPMG, "Tax Brief – KPMG Update on Current Issues and Trends in Korean Tax" (2009) 54, January issue (available at www.kr.kpmg.com), accessed on 16 April 2009.

¹⁰ South Korea introduced a consolidation regime in 2010: IBFD, "Country Analysis – Republic of Korea – Corporate Taxation (online database)" (available at www.ibfd.org), accessed on 30 April 2010. However, as little information is available on its detailed rules and actual implementation, it is not analysed in detail in this book. Canada had a consolidation regime from 1932 to 1952. For a brief discussion of the regime, see

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The comparative analysis has two main objectives. First, it provides a comprehensive comparison of the eight consolidation regimes. The comparative study identifies the key structural elements of a consolidation regime, and the respective alternative policy solutions adopted in the eight countries. The alternative policy options are compared and evaluated critically against generally accepted tax policy objectives including simplicity, neutrality and competitiveness. Second, based on the findings of the comparative study of the eight consolidation regimes, the book intends to search for a model consolidation regime, representing the best practice in respect of the key structural elements on policy grounds. The model regime should be of particular interest to countries considering the introduction of a consolidation regime.

It is important for tax policy makers in a country to be aware of the policy solutions adopted in other countries. This is useful not only for the eight countries which may need to fine-tune their existing consolidation regimes, but also for other countries that contemplate the introduction of a consolidation regime. Experience suggests that once a consolidation regime is introduced, it is unlikely to have major structural changes in the regime. Businesses enjoy the benefits of intra-group loss offsets and tax free asset transfers under the consolidation regime. Repeal of the regime is therefore most likely politically unacceptable. Fine-tuning is often the only feasible approach in practice. Therefore, it is important for countries that contemplate the introduction of a consolidation regime to get the legislation right when it is first introduced. Of course, a policy that is effective and appropriate for one country may not be so for another. Transplanting a policy solution from one country to another without due consideration of the local circumstances and constraints

Stephen Richardson, "Transfers of Deductions, Credits, or Losses within Corporate Groups: A Department of Finance Perspective" in Canadian Tax Foundation, *Report of Proceedings of the Thirty-sixth Tax Conference* ("CTF 1984 Conference Report") (1985, Canadian Tax Foundation, Toronto), at 738–739. The regime was similar to the US counterpart, but much simpler: at the time of its repeal, the regime was "contained in one section of 11 subsections": *ibid.*, at 739; see also Robert Couzin, "Income Taxation of Groups of Corporations: The Case for Consolidation" in CTF 1984 Conference Report, at 719. The government's rationale for repealing the regime was that the introduction of the general business loss carryover rules had made the consolidation regime unnecessary, but the justification was not very convincing to many commentators: see for example Stephen Richardson, "A Corporate Loss Transfer System for Canada: Analysis of Proposals" in Canadian Tax Foundation, *Report of Proceedings of the Thirty-seventh Tax Conference* (1986, Canadian Tax Foundation, Toronto), at 12:2; and Couzin, *ibid.*, at 720.

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can be hazardous, as the policy solution in a country may be the compromise between conflicting policy objectives and political forces particular to that country.

Nevertheless, important lessons may be learnt from an examination of alternative policy options in other countries. Countries often face similar problems in their income tax systems. It can be helpful for a country to examine other countries' experience in an attempt to identify policy options for addressing common tax problems. If a policy option is proved to be effective in another country, it may be possible to adopt the same solution in the country, subject to modifications with respect to the domestic context and constraints. Important lessons may also be learnt from other countries' less successful experience which can help a country to avoid making similar mistakes.

The comparative analysis serves another purpose. Consolidation regimes in the eight countries apply, to considerably different extents, the enterprise doctrine under which a corporate group is treated as one single taxpayer. The eight regimes represent a spectrum, ranging from the pooling system (for example, in France) – under which each consolidated member remains to a large extent a separate entity for income tax purposes – to the “asset-based” model in Australia, under which all consolidated subsidiaries are effectively deemed to have become divisions of the parent company and ceased to exist for income tax purposes.¹¹ The comparative analysis provides an opportunity to answer the following important tax policy question: does a stronger application of the enterprise doctrine necessarily imply a better consolidation regime on policy grounds?

The consolidation regime in each of the eight countries has been studied at considerable depth in the respective countries. However, very few comparative research studies have been undertaken for two or more countries.¹² Little, if any, has been written on the comparison and evaluation

¹¹ Australia's consolidation regime allows trusts and partnerships to be consolidated members. However, for the purpose of this book and to facilitate the comparative analysis with other countries, the discussion focuses on companies that are recognised by the tax law. Companies that are regarded as flow-through entities are not analysed in detail.

¹² See for example Antony Ting, “Policy and Membership Requirements for Consolidation: A Comparison between Australia, New Zealand and the US” (2005) 3 *British Tax Review* 311. For a comparison between the consolidation regimes in Australia and the US, and the treatment of corporate losses in Canada, see Maureen Donnelly and Allister Young, “Policy Options for Tax Loss Treatment: How Does Canada Compare?” (2002) 50(2) *Canadian Tax Journal*, at 449–470.

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of the consolidation regimes of all the eight countries. This book aims to fill the gap.

This comparative study adopts the common core approach under which the key structural elements of a consolidation regime are first identified. The alternative policy solutions adopted in the eight countries for the common key structural elements are then compared and evaluated against well-established tax policy objectives. As the comparative study focuses on the key structural elements of a consolidation regime, detailed discussion of each consolidation regime – which is often one of the most complex regimes in a tax system – is beyond the scope of this book. This study does not, and is not designed to, cover all detailed technical provisions of the eight consolidation regimes.

The key structural elements of a consolidation regime analysed in this book are:¹³

- (1) The single entity concept;
- (2) Consolidation of group results;
- (3) Liability to tax;
- (4) Election to consolidate;
- (5) The “all in” rule;
- (6) Definition of a group;
- (7) Treatment of pre-consolidation losses;
- (8) Treatment of consolidated group’s losses;
- (9) Treatment of assets; and
- (10) Treatment of intra-group shares.

The first key structural element – the single entity concept – is the fundamental policy underlying a consolidation regime, and often affects the policy options for other structural elements. Therefore, it is analysed first. The second and third key structural elements deal with how a consolidated group computes its taxable income and who is liable to pay the consolidated group’s tax liability. The fourth structural element focuses on whether an election to consolidate is revocable or not. The next two

¹³ The items in the list may be classified in different ways. For example, the treatment of pre-consolidation losses, and of assets at joining time (that is, when a subsidiary joins a consolidated group) and at leaving time (that is, when a subsidiary leaves a consolidated group), are transitional issues which arise when a company joins or leaves a consolidated group. However, for the purposes of this comparative study, they are listed as shown to facilitate the comparison of related issues. For example, the policy options of assets at joining time, during consolidation and at leaving time are often interrelated and therefore are analysed together.