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Is VAT also a Corporate Tax? Untangling Tax Burdens and Benefits for Companies

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1. Introduction

Since the Great Financial Crisis there has been concern in many countries about whether corporations are paying a 'fair' amount of tax. This begs the question of what a 'fair' amount of tax is. Since corporate income tax ('CIT' – corporation tax in the UK) is based on the amount of profit of corporations, arguments based on the amount of sales revenue (turnover) of a corporation are of limited validity unless there is some information about the corporation's profit margin. More realistically, it has been suggested that the proportion of the sales revenue earned by a corporate group in a country is a guide to the amount of the group's profit that should be taxed in that country.[2] This is not in principle an unreasonable position, but it is a novelty in terms of how the international tax system has operated for the last hundred years or so.[3] In addition, the European Union and a number of its member states are considering possible approaches to taxing groups in the technology sector that could include a tax on turnover.[4]

Of course, there is already a tax based on sales that corporations pay in many countries, value-added tax (VAT), known in some countries as goods and services tax (GST). This is generally considered to be a tax on consumption, and one of its important features is that businesses that collect it are neutral as to whether they have to pay it on any of their own purchases, because they are in normal cases entitled to a

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[2] See *e.g.* Maarten de Wilve, 'Tax jurisdiction in a digitalizing economy; why 'online profits' are so hard to pin down' (2015) 43(12) Intertax 796.
[3] See *e.g.* Reuven S. Avi-Yonah , 'Double Tax Treaties: An Introduction' (2007), available at SSRN <http://ssrn.com/abstract=1048441> accessed 3 October 2019; OECD, *Model Tax Convention on Income and on Capital: Condensed Version*, (2017) OECD Publishing, Paris, <https://doi.org/10.1787/mtc_cond-2017-en> accessed 3 October 2019; Roy Rohatgi, *Basic International Taxation, Vol.1, Principles of International Taxation* (2nd ed. Richmond: Richmond Law & Tax, 2005).
[4] European Commission Staff Working Document, 'Impact assessment accompanying the document 'Proposal for a Council Directive laying down rules relating to the corporate taxation of a significant digital presence' and 'Proposal for a Council Directive on the common system of a digital services tax on revenues resulting from the provision of certain digital services' (2018) <https://ec.europa.eu/taxation_customs/sites/taxation/files/fair_taxation_digital_economy_ia_21032018.pdf> accessed 3 October 2019.

credit for the VAT paid. In fact, it was because of this advantage that VAT was originally introduced in European countries as a replacement for general taxes on turnover.[5]

This paper seeks to explore an illustration of how VAT can, whether deliberately or not, impose an inherent burden on corporations. The issue arises in an interesting series of cases before the European Court of Justice,[6] but also raises issues concerning the principles that lie behind VAT. Moreover, it has potential lessons for the ways in which we tax corporations, particularly in light of new proposals such as the EU idea of a turnover tax and the idea of a destination-based cash-flow tax included in proposals of the Republicans in the US House of Representatives in 2016.[7]

A central issue in this debate is about how to tax groups of companies, which at the top end is about the appropriate tax treatment of multinational enterprises (MNEs, also called transnational companies or TNCs). Internationally, CIT treats each company in a group as a separate entity, and then uses transfer pricing rules to adjust the allocation of profits, although this system has been questioned and faces challenges from versions of formulary apportionment, an approach that starts from the income of the entire group, and then allocates it to countries where the group operates, as well as various intermediate systems.[8] Domestically, the base transfer pricing rule is also typically to tax each company separately, although many countries offer at least an option to recalculate the tax treatment to recognise the group in some form. This divergence reflects the fact that there is no clear consensus on how groups should be subject to CIT. Moreover, while recognition of the group domestically tends to reduce the overall tax burden, internationally group approaches are generally sought to achieve the reverse.

Since value added taxes (VATs)[9] are typically intended to be taxes on consumption, how they treat groups should be conceptually clearer. The tax is intended to burden consumers, not businesses. Indeed, one of the principal virtues of a VAT is that, by not burdening business, it is supposed not to distort the behaviour or structure of businesses. Of course, in practice VATs deviate from the ideal structure in many ways, and these imperfections can impose burdens on businesses.

[5] Walter Hellerstein and Timothy H Gillis, ‘The VAT in the European Union’ (2010) 127 Tax Notes 461. See also the original version of the Treaty of Rome (1957) art. 99. (“The Commission shall consider how the legislation of the various Member States concerning turnover taxes, excise duties and other forms of indirect taxation, including countervailing measures applicable to trade between Member States, can be harmonised in the interest of the common market”).

[6] In this article the old term ‘European Court of Justice’, abbreviated to ECJ, is used for clarity to refer to the Court of Justice, which is part of the Court of Justice of the European Union: article 19(1) of the Treaty on European Union.

[7] House Republicans Tax Reform Task Force, ‘A Better Way: Our Vision for a Confident America’ (2016), available at <https://morningconsult.com/wp-content/uploads/2016/06/ABetterWay-Tax-PolicyPaper-.pdf> accessed 20 October 2019.

[8] See eg Alexander Hartley, ‘Digital tax: The loose thread unravels’ (22 Aug. 2019) Int’l Tax Rev, available at <https://search-proquest-com.gate3.library.lse.ac.uk/docview/2295315942?accountid=9630>.

[9] Some countries, especially English-speaking Commonwealth countries, call their VATs goods and services taxes or GSTs, but the underlying system is the same, and the term ‘VAT’ is used generically here to refer to both VATs and GSTs.

In principle, VAT should automatically leave groups unburdened. Transactions between businesses are subject to VAT, but the recipient is normally entitled to a credit or deduction (the terms are used equivalently in different systems) of the VAT paid on the inputs it acquires from other businesses. Many VAT systems offer a group regime. The main benefit of a group regime is to eliminate accounting for the offsetting charges to and credits for VAT on intra-group transactions, but entry to the group regime can be subject to restrictions to limit opportunities for VAT avoidance that can arise by selectively including companies in a group and on entry or exit from a group. Nevertheless, the principle of VAT means that, in contrast to CIT, VAT ought not to impose any additional burden on groups.[10]

The main problem to ensuring that VAT does not burden businesses or distort business activity is VAT exemptions, because these exemptions of outputs from VAT entail that the supplying businesses lose the right to deduct VAT on their corresponding inputs. This is especially a problem when the outputs are provided to other businesses, as it results in cascading. The denial of exemption means that the non-deductible input VAT is a cost to the exempt business, which is potentially added to the business's output prices. Businesses purchasing the exempt outputs are paying VAT without the ability to deduct it (since they do not pay it as VAT), so it is potentially added to the base on which they charge VAT, further increasing the additional price to the ultimate consumer.

The main exemptions that can have this effect are those for financial services and for land (real or immovable property). In both cases the exemptions are widely used because it is difficult to apply a proper VAT treatment to these transactions without either under or over taxing them.[11] The issue that specifically affects groups is that the exempt financial services typically include transactions in shares. This means that input VAT associated with the shareholdings that establish the group structure, such as fees of lawyers, accountants, investment bankers and other advisers, could become non-deductible. This would make VAT a burden on corporate structures and corporate structuring. It could affect not only acquisitions and restructurings, but also the ongoing operations resulting in the payment of dividends. The effect would be most pronounced in the case of holding companies, since they will tend to have few if any other activities, so there would be a risk that none of their input VAT would be deductible.

In terms of the overall finances of a group, let alone a large MNE, this may seem a minor item, but it goes to the heart of the conception of how tax should affect the

[10] The contrast to CIT depends on what the baseline is for CIT. An 'ideal' comprehensive von Schanz-Haig-Simons CIT with full refundable loss offsets and a single rate could be similarly neutral for groups, but is unlikely to be feasible. Arguably a VAT that was fully neutral to groups is more foreseeably feasible, and is thus a more realistic baseline.

[11] A proper discussion of the underlying problems with these transactions is beyond the scope of this article, but it will suffice here to note that the problem with financial services is that the typical provider is a financial intermediary, such as a bank, remunerated for providing financial intermediation out of only a portion of the interest charged or paid to its customers.

corporate structures of groups. Moreover, it does so in a way that does not have an obvious public policy objective.[12]

It turns out that solving this problem within the general rules of VAT is surprisingly difficult. Some countries, such as Canada and Switzerland, have dealt with it with legislation, which ducks the conceptual issues.[13] The case of the European Union is more interesting, because there the task has been left to the European Court of Justice, which has come up with a solution that seems to be reasonably effective, although it uses a mechanism that does not look very appropriate. However, the reasoning of the ECJ highlights what the conceptual problems are, which can help in devising a more coherent solution.

2. The Tale of Holding Companies and the ECJ

To understand how the ECJ developed its solution, it is necessary to start at the beginning. This story is about the EU version of VAT as it operates in all EU countries under the terms of the VAT Directive, which recast the First and Sixth Directives in similar terms.[14] VAT is in principle charged on the taxable amount of all supplies of goods and services by a taxable person. The concepts of taxable amount, supplies of goods and services, and taxable person are all very broadly defined. The taxable amount is normally the full amount of consideration received for a supply. A taxable person is defined in article 9(1) as 'any person who, independently, carries out in any place any economic activity,' whether for profit or not. Economic activity includes all usual business activities, but also the 'exploitation of tangible or intangible property for the purposes of obtaining income therefrom on a continuing basis.'

12 One could argue that it could be seen as valuable to impose a greater burden on more complex corporate structures on the argument that they tend to have anti-competitive implications. This echoes arguments made by Marjorie Kornhauser ('Corporate Regulation and the Origins of the Corporate Income Tax' (1990) 66 Ind. L.J. 53) and Reuven Avi-Yonah ('Corporations, Society, and the State: A Defense of the Corporate Tax' (2004) 90 Va L Rev 1193-1255), as well as, in a different context, the original argument for the Tobin tax on foreign exchange transactions, but would be a similarly blunt tool. In any case, CIT would seem to be a more appropriate vehicle, since it is a tax on corporates.

13 For Canada see *Excise Tax Act*, R.S.C., 1985, c. E-15, s. 186, available at <https://laws-lois.justice.gc.ca/eng/acts/E-15/page-80.html#h-192633> accessed 1 December 2019; for Switzerland see Federal Act of 12 June 2009 on Value Added Tax, Art. 29 paras 2-4, available at <https://www.admin.ch/opc/en/classified-compilation/20081110/index.html> accessed 1 December 2019.

14 Council Directive 2006/112/EC of 28 November 2006 on the common system of value added tax [2006] O.J. L347/1 (VAT Directive). It replaced the First Council Directive 67/227/EEC of 11 April 1967 on the harmonisation of legislation of Member States concerning turnover taxes [1967] OJ 71 /1301 (First Directive), and the Sixth Council Directive 77/388/EEC of 17 May 1977 on the harmonisation of the laws of the Member States relating to turnover taxes – common system of value added tax: uniform basis of assessment [1977] O.J. L145/1 (Sixth Directive), from 2008. Given its title and the existence of other directives on VAT, a better short title for the VAT Directive would be the VAT Common System Directive, but 'VAT Directive' has gained currency. HMRC and some others in the UK refer to the 'Principal VAT Directive'.

There are a number of exemptions for certain types of supplies, notably, in the present context, in respect of a number of supplies of financial services.[15] Businesses making exempt supplies are not entitled to a credit for VAT on purchases and other inputs that they acquire for the purposes of the exempt supplies.[16] As a result the uncredited VAT on those inputs (input VAT) is a cost to the businesses, a burden that businesses often seek to avoid.[17] Article 135(1)(f) provides for the exemption of 'transactions, including negotiation …, in shares, interests in companies or associations, debentures and other securities ….' This should exempt sales of shares.[18] What about dividends? Dividends are payments, so one might expect that they would in principle they should be subject to VAT as consideration for some supply; however, it is not self-evident that this supply would fall within 'transactions in shares' or any other supply listed in art 135(1)(f).[19] This proves to be a question at the core of the cases on holding companies.

1.1. The Starting Point – *Polysar*

The cases in this story begin in 1991 with the *Polysar Investments* case.[20] Polysar Investments Netherlands BV was an intermediate holding company serving as owner of the European subsidiaries of Polysar Ltd, the parent of a Canadian group.[21] Apparently, its only activities were receiving dividends from its subsidiaries and paying them out to its parent. In the course of doing this it paid for certain services, such as accounting services, on which it was charged VAT. It sought to have the VAT refunded.

Polysar argued that it was a taxable person because it was exploiting shares (intangible property) to obtain income from them on a continuing basis, and that, in

[15] These exemptions are to be found in article 135. Other exemptions deal principally with various public interest supplies (roughly, health, education and certain non-profit activities), certain transactions relating to immovable property.

[16] Strictly speaking the credit is for VAT on any acquired goods and services (inputs) used for making supplies (outputs): art 168 et seq. Exempt supplies of this sort are not to be confused with supplies that are exempt with right of deduction (the main EU instances being listed in art 169), which in the UK, and in much of the wider VAT literature, is called zero rating, since the effect is the same as charging VAT at a rate of zero. Note that the VAT Directive (and its predecessors) use the term 'deduction' rather than 'credit'. The latter term is used here for clarity, since in tax literature more generally 'credit' can be used to designate a reduction in the amount of tax, as opposed to a deduction from the amount on which tax is charged.

[17] There are many cases that are examples of this, such as Case C-103/09 *HMRC v Weald Leasing Ltd* ECLI:EU:C:2010:804, [2010] ECR I-13589, [2011] STC 596.

[18] See notably Case C-4/94 *BLP Group plc v C&EC* EU:C:1995:107, [1995] I-983, [1995] STC 424.

[19] Contrast this with art 135(1)(b), exempting 'the granting and the negotiation of credit'. It is not hard to see that the consideration for the granting of credit is (typically) the payment of interest. See e.g. Case C-281/91 *Muys' en de Winter's Bouw-en Aannemingsbedrijf BV v Staatssecretaris van Financiën*, [1993] ECR I-5405, [1997] STC 665.

[20] Case C-60/90 *Polysar Investments Netherlands BV v Inspecteur der Invoerrechten en Accijnzen te Arnhem* ECLI:EU:C:1991:268, [1991] ECR I-3111, [1993] STC 222.

[21] For convenience Polysar Investments Netherlands BV is referred to hereafter as 'Polysar', despite the similar name of the Canadian ultimate parent. Its immediate parent was Polysar Holding Ltd, another Canadian corporation.

light of other cases, to treat them otherwise would discriminate between the investment and management of tangible versus intangible property, as well as between holding companies using equity and those using external debt finance.[22] Further, while it accepted that its outputs (represented by dividends) were exempt under what is now art 135(1)(f) as transactions in shares,[23] it argued that it had a right to a credit for the input tax as part of a worldwide group carrying on taxable economic activity. Polysar appears to have raised an alternative argument that its outputs gave a right to a credit for the disputed input tax under what is now art 169(c),[24] which provides for a credit where inputs are used for otherwise exempt financial services provided to a customer outside the Community (in Canada in this case). These arguments were never very coherent. While there are optional provisions for VAT groups (used by both the Netherlands and the UK), they only apply to recognized domestic groups, and there was no suggestion that Polysar had such recognition. The argument on the current art 169(c) is also not very strong, since it must be based on an argument that Polysar was supplying some service to the parent, presumably in paying dividends. But a payment made is normally consideration for receiving, not supplying, a service.

The case was decided on the question of whether Polysar was a taxable person or not, but it is helpful to start with the question of whether it could have got a credit for its input tax if it had been a taxable person. Advocate General Van Gerven took the view that Polysar did not have outputs exempt under what is now art 135(1)(f) as 'transactions in … shares', because this did not apply to 'the exercise by the shareholder of the rights attaching to his shares.'[25] Nor did the exemption in what is now art 135(1)(d) for 'transactions … concerning payments, transfers, [etc.]' apply to payments within a company such as a dividend to shareholders.[26] From the context the Advocate General appears to have been referring in the first case to the dividends received by Polysar, and in the second case to the dividends paid by Polysar, without considering whether either or both represented outputs, either as supplies or as consideration for supplies.[27] The exemption point was not considered by the ECJ, as it decided the case on the taxable person point.

The ECJ's conclusion was that Polysar was not a taxable person. It reached this conclusion on the basis that, although the Directive gives VAT a very wide scope,

22 *Polysar* (n 20), Report for the hearing, para 12.
23 Formerly, Sixth Directive, art 13B(d)5.
24 Formerly, Sixth Directive, art 17(3)(c).
25 *Polysar* (n 20), Opinion of AG Van Gerven, para 13.
26 ibid. VAT Directive art 135(1)(d) was formerly Sixth Directive art 13B(d)3.
27 The question of whether dividends received or paid could represent output transactions for VAT purposes does not appear to have been discussed as such. Some of Polysar's arguments appear to be based on the idea that dividends received could be seen as consideration for the supply of capital by the shareholder. However, the Advocate General refers (at para 11) to 'activities engaged in by a holding company … which form part of the company's internal operations, in particular in its relations with its own shareholder(s)', as also not constituting 'economic activities' under art 2 that might be regarded as taxable for VAT purposes. In saying this he appears to be contemplating that the payment of dividends might somehow constitute an output transaction, though he does not offer any explanation. Of course, since he concludes that the activities are not 'economic activities', he has no need to, but this does not lend clarity to the Opinion.

Polysar's activities did not constitute 'exploitation' of intangible property, based on the approach taken in the *van Tiem* case. In that case the taxpayer granted building rights to a company. The Court said,

> '[given] the principle that the common system of VAT should be neutral, the term "exploitation" refers to all transactions, whatever may be their legal form, by which it is sought to obtain income from the goods in question on a continuing basis.
> 'Therefore, the grant by an owner of immovable property to a third party of a building right over that property must be deemed to be an exploitation of the property if that right is granted in return for a consideration for a specified period.'[28]

Earning dividends from shares did not fit within this concept, because the dividends were merely the consequence of ownership.[29] There was no separate transaction, such as a letting, that gave rise to the returns and that could constitute exploitation.

The Court then added, rather ambiguously: 'It is otherwise where the holding is accompanied by direct or indirect involvement in the management of the companies in which the holding has been acquired, without prejudice to the rights held by the holding company as shareholder.'[30] This sounds like a case where a holding company is not merely a passive investor, but takes an active role in planning the strategy of its subsidiaries. The Advocate General did not agree with this implication. He thought that a company might go beyond being a mere investor if it were actively buying and selling shares, but not by exercising shareholders' rights, such as voting at the annual meeting or for directors, in order to influence policy.[31] The French government argued that a holding company would be a taxable person if it also made loans to its subsidiaries (as this would constitute granting credit, which is clearly economic activity since it is expressly made exempt), or provided services to its subsidiaries in return for management fees.[32] On the other hand, the Commission argued that investment activities going beyond merely receiving dividends could be sufficient to make a holding company a taxable person.[33]

The Court and the Advocate General dismissed the grouping argument on the basis that a company cannot be considered to be part of a group for VAT purposes unless the individual company is first carrying on economic activity so as to be a taxable person.

What is peculiar about the *Polysar* case is that it seems, at least initially, to go against the idea of the neutrality of VAT. The implication is that if an enterprise inserts a holding company in its corporate structure, VAT on the costs of operating the holding company will not be creditable. Surely VAT ought to be neutral to the way in which an enterprise is structured, given the importance of neutrality to the VAT system. The

28 Case C-186/89 *van Tiem v Staatssecretaris van Financiën* [1990] ECR I-4363, [1993] STC 91, paras 18-19.
29 *Polysar* (n 20) para 13. See also ibid, Opinion of AG Van Gerven, para 5.
30 ibid para 14.
31 ibid, Opinion of AG Van Gerven, paras 5-6.
32 ibid, Report for the hearing, para 14.
33 ibid, paras 17-19.

Advocate General argued that if a holding company were considered to be a taxable person by virtue of earning dividends, then any shareholder would also have to be treated as a taxable person for VAT.[34] This seems to confuse an investor with a management structure. It is also pertinent to ask to what extent was the case influenced by the fact that it was likely that Polysar was inserted in the structure for corporate income tax reasons.[35]

In a later important case, not about holding companies, the ECJ made the distinction between investors and economic actors in the other direction. When Wellcome Trust Ltd disposed of most of the shareholding that it held as charitable trustee in Wellcome Foundation Ltd by an extensive managed tendering process, the Court found that it was, nevertheless, still acting as private investor, and was not, therefore, carrying on economic activity or a taxable person.[36] Thus in *Polysar* the ECJ could be seen as analogising a holding company with no management role to an investor (*i.e.* one performing part of the role of a shareholder), and a holding company with a management role to a management structure (*i.e.* something carved out of the underlying corporations in the group).

1.2. Holding Companies with Fees

The story continues with the *Sofitam* case.[37] Sofitam SA (which had been called Satam SA at the time of the events in dispute) was the ultimate holding company of a French group. Unlike Polysar, in addition to receiving dividends Sofitam let out real property (which was subject to VAT) and provided services to its subsidiaries in return for fees, so it was clearly a taxable person, but it was not involved in the management of its subsidiaries beyond exercising its rights as shareholder.[38] Here it was the dividends received that were seen as representing outputs. This meant that it had revenues from its taxable services and in the form of dividends. Where a taxable person makes both taxable and exempt supplies, it can only get credit for inputs used to make the taxable supplies. The default rule to determine how much credit it gets is a simple proportion: the ratio of the value of its taxable outputs giving a right to a credit to the value of its total outputs.[39] Sofitam argued that it did not have to include the dividends in either side of the fraction, thereby apparently giving credit for (virtually?) all of its input tax.

The Court affirmed its position in *Polysar* that a passive holding company had no economic activity because ‘mere acquisition of financial holdings in other companies did not constitute an economic activity’. This meant that dividends were not consideration for any economic activity and had to be excluded from the partial exemption proportion. This was necessary in order that ‘the objective of wholly

34 ibid, Opinion of AG Van Gerven, para 5.
35 See *Polysar* (n 20), Opinion of AG Van Gerven, para 1.
36 Case C-155/94 *Wellcome Trust Ltd v C&EC* EU:C:1996:243, [1996] ECR I-3013, [1996] STC 945. As part of the transactions Wellcome Foundation Ltd was converted into Wellcome plc, which survives today, following several mergers and acquisitions, as part of Glaxo Smith Kline plc.
37 Case C-333/91 *Sofitam SA (formerly Satam SA) v Ministre chargé du Budget* ECLI:EU:C:1993:261, [1993] ECR I-3513, [1997] STC 226.
38 ibid, Opinion of AG Van Gerven, para 2.
39 VAT Directive, arts 173, 174(1).

neutral [VAT] taxation … is not … jeopardised'.[40] Even though Sofitam was apparently not involved in the management of its subsidiaries, because it had other activities it was, unlike Polysar, effectively able to get the credit that was unavailable to Polysar. The extent to which this achieves neutrality is becoming less clear at this point in the story.

The next step came in the *Floridienne* case from Belgium.[41] Floridienne SA was the holding company of the whole group, while Berginvest SA was an intermediate holding company in the group at the head of one of its divisions. The two holding companies received dividends, but also claimed to be involved in managing the subsidiaries 'in particular by supplying them with administrative, accounting and information technology services and with loan finance'.[42]

The Court said that this case was different from *Polysar* and *Sofitam* because of the involvement in the management of the subsidiaries could be economic activity. However, the Court added that 'involvement of that kind in the management of subsidiaries must be regarded as an economic activity … in so far as it entails carrying out transactions which are subject to VAT, such as the supply by Floridienne and Berginvest of … services to their subsidiaries'.[43] In other words, involvement in management of subsidiaries is only economic activity in so far as it is provided for a fee. Otherwise it is just shareholder activity.

The issue in the case was the same as that in *Sofitam*: did the companies have to include the dividends received in their partial exemption proportion? Notwithstanding the involvement in management, if they were to be included, the dividends still had to be consideration for some economic activity. This the Court rejected as in *Sofitam*. This time the Court explained the features of dividends that prevented them being consideration: they are only payable if the paying company has profits available for distribution, the amount received by each shareholder is determined by the shareholding, unaffected by the identity of the shareholder, *i.e.* by any active involvement in management, and, following *Polysar*, 'dividends represent, by their very nature, the return on investment in a company and are merely the result of ownership of that property'.[44] An essential feature of consideration, a direct link to the supply for which it is meant to be consideration, was, therefore, missing in the case of dividends. Similarly, the loan finance also represented no economic activity since it merely involved reinvesting dividends received. It would have been different if the loans had been made to earn interest and 'with a business or commercial purpose characterised by, in particular, a concern to maximise returns on capital investment'.[45]

The next high point comes with the *Cibo Participations* case.[46] Cibo Participations SA (Cibo) was set up by its majority corporate shareholder to hold the shares in three

40 *Sofitam* (n 37) paras 13, 14.
41 Case C-142/99 *Floridienne SA and Berginvest SA v Belgian State* ECLI:EU:C:2000:623, [2000] ECR I-9567, [2000] STC 1044.
42 ibid, Report for the hearing, para 6.
43 ibid, Judgment, paras 18-19.
44 ibid para 22.
45 ibid para 28.
46 Case C-16/00 *Cibo Participations SA v Directeur regional des impôts du Nord-Pas-de-Calais* EU:C:2001:495, [2001] ECR I-6663.

subsidiaries. The referring court specifically asked for an explanation of what was required to establish 'involvement in management'. Cibo provided services to the subsidiaries in return for fees and provided staff to the subsidiaries in return for 0.5% of their turnover. In addition, its chairman was also chairman of the subsidiaries. The French government characterised it as receiving compensation for providing consulting and direction of group policy to the subsidiaries.[47] But the distinguishing feature of this case was that the fees paid with VAT for which Cibo sought to get a credit for the VAT had been paid in connection with the acquisition of the shares of the subsidiaries. The argument was, therefore, that the fees paid were unrelated to Cibo's economic activity and should not give rise to a VAT credit.

Although the French government argued that involvement in management must mean having a 'decisive influence' over the subsidiaries,[48] the Court held to its position in *Floridienne* that involvement in management meant providing services to the subsidiaries for a fee, 'such as … administrative, financial, commercial and technical services'.[49] On the basis of *Sofitam* and *Harnas & Helm*,[50] a case about an investment fund, it confirmed that the mere acquisition of shares by a holding company was not itself economic activity. It did not amount to exploitation of property, since the returns, dividends, were 'merely the result of ownership'.[51]

That still left the question of the creditability of the VAT on the fees for the acquisition of the shares. The argument against Cibo was based on *BLP Group*, in which the ECJ had established that VAT on inputs could only be credited if the inputs had a 'direct and immediate link' to taxable outputs, regardless of the taxpayer's ultimate aim.[52] Since that decision, however, the Court had developed an argument that costs with no direct and immediate link to any output transaction could be said to be part of the general overheads, and might thus be said to be cost components of the taxpayer's products.[53] 'Such services therefore do, in principle, have a direct and immediate link with the taxable person's business as a whole'.[54] The result was that, although the dividends were very much the largest part of Cibo's revenues, they were to be ignored for purposes of determining the available VAT credits, but Cibo was entitled to a credit for the VAT on the cost of acquiring the shares producing the dividends.[55]

[47] ibid paras 10-11.
[48] ibid para 16.
[49] ibid para 21.
[50] Case C-80/95 *Harnas & Helm CV v Staatssecretaris van Financiën* EU:C:1997:56, [1997] ECR I-745, [1997] STC 364.
[51] *Cibo* (n 46) para 19.
[52] *BLP Group* (n 18), para 19.
[53] The argument was developed in Case C-98/98 *Midland Bank plc v C&EC* ECLI:EU:C:2000:300, [2000] ECR I-4177, [2000] STC 501, and Case C-408/98 *Abbey National plc v C&EC*, ECLI:EU:C:2001:110, [2001] ECR I-1361, [2001] STC 297.
[54] *Cibo* (n 46) para 33.
[55] In principle this credit would be limited by Cibo's partial exemption ratio, but its ratio would seem to have effectively been 100 per cent, since Cibo does not appear to have made any exempt supplies.

The *Cibo* case has set the clear direction of the ECJ on this issue. Subsequent cases have continued the trends. While some have elements of novelty, they do not make any significant difference to the essentials of the story.[56]

3. Understanding VAT and Holding Companies

The real problem that the ECJ faced in the later holding company cases was that the scheme of the VAT Directive is to exempt financial services, and so also returns on financial services, in principle including dividends and interest, but, at least for domestic holding companies, the Court felt that they should not be disadvantaged, as long as they had some taxable activity to which the input VAT credit could be attributed. The exception was *Polysar*, where the holding company really did look like a shell company, and one with a dubious (income) tax avoidance motive for its existence. The difficulty with the subsequent cases is that they seem to undermine the logical conclusion in *BLP Group* that exempt output transactions are part of the scheme of VAT, and that taxpayers have to accept that the consequence is the loss of credit for VAT on inputs used for those transactions. If that is the general principle, why should holding companies get any different treatment?

One approach to the answer comes from the discussion above about whether there is a distinction between a private investor on the one hand, even one with a large portfolio, who manages the investments in a sophisticated and organised manner, perhaps involving a number of staff as well as (expensive) outside advisors, and, on the other hand, a holding company that is part of an enterprise – the group comprising parent and subsidiaries.

Another approach can be seen in an argument made by the French government in *Polysar*.[57] One might regard an investment in shares as involving making capital available to the corporation invested in. The consideration for this supply of making capital available would then be the dividends. This would seem to fit with the concept of the exploitation of intangible property on a continuing basis to produce an income, referred to in article 9(1) of the VAT Directive, and with the apparent exemption for dividends and connected with transactions in shares (the acquisition of the shares) in article 135(1)(f). The problem with this argument is that VAT is based on charging tax on all supplies with a credit for the tax on all *cost components* of making the supplies, however many steps there are in the chain of production. This is what gives neutrality in the conditions of competition. But dividends are not cost components, since they represent a share of the profits left after the costs have been paid, and so conceptually they cannot be consideration for any service. This argument references

[56] Leading and recent examples include: Case C-77/01 *Empresa de Desenvolvimento Mineiro SGPS SA (EDM) v Fazenda Publica (Ministério Público intervening)* [2004] ECR I-4250, [2005] STC 65; Case C-29/08 *Skatteverket v AB SKF* EU:C:2009:665, [2009] ECR I-10413, [2010] STC 419; Joined cases C-108/14 and C-109/14 *Beteiligungsgesellschaft Larentia + Minerva mbH & Co KG v Finanzamt Nordenham, Finanzamt Hamburg-Mitte v Marenave Schiffahrts AG* EU:C:2015:496, [2015] STC 2101; Case C-320/17 *Marle Participations SARL v Ministre de l'Économie et des Finances* [2018] STC 1904; and Case C-249/17 *Ryanair Ltd v Revenue Comrs* EU:C:2018:834 (17 October 2018).
[57] *Polysar* (n 20), Report for the hearing, para 14.

the terminology of the basic principles of VAT from the First Directive, now found in the VAT Directive, art 1(2):

> ‘The principle of the common system of VAT entails the application to goods and services of a general tax on consumption exactly proportional to the price of the goods and services, however many transactions take place in the production and distribution process before the stage at which the tax is charged.
>
> ‘On each transaction, VAT, calculated on the price of the goods or services at the rate applicable to such goods or services, shall be chargeable after deduction of the amount of VAT borne directly by the various cost components.’

1.3. [3.1] The basis of VAT input and output transactions, and distributions to factors

In fact, the argument goes to the economic fundamentals of VAT. VAT, as structured in the EU and in most other VAT and GST systems in the world, is both a consumption tax and a tax on value added. It can be said to be a tax on consumption because the system of crediting means that a VAT is not a burden for a taxable business, as the business gets a credit for any VAT it pays to its suppliers. It also knows that its taxable business customers will get a credit for any VAT that it charges them. The only customers who thus bear the burden of VAT are consumers.

This is subject to the effects of exemptions. If exemptions break the chain of crediting, they bring a risk of distorting competition. The exemptions in the public interest are typically applied to certain goods and services normally provided to consumers (such as health and education), so in those cases it is normally only the final stage of production that is being exempted, which limits the risk of competitive distortion. Exemptions are used for financial services and land transactions because those are two areas where it is very difficult to apply the normal rules of VAT effectively for a number of reasons.[58]

To understand VAT alternatively as a tax on value added, consider how VAT affects a fully taxable firm. The firm charges VAT (output tax) on all its sales. It pays VAT (input tax) on all its purchases. It gets a credit for the input tax, so the amount it pays to the tax authority is the difference between the amount of the output tax and the amount of the input tax. If there is only one VAT rate, this will be equal to the tax rate times the difference between the value of sales and the cost of the inputs. This difference can be said to measure the amount of value that the firm has added to the inputs purchased. So VAT is a tax on this added value. Ignoring the exempt items

[58] The exemptions for financial services appear to be offered a justification by what the Meade Report called the R basis for consumption tax, as opposed to the $R + F$ basis. See J. E Meade et al., *The Structure and Reform of Direct Taxation: Report of a Committee Chaired by J.E. Meade* (Allen and Unwin for the Institute for Fiscal Studies 1978) 230-38 <www.ifs.org.uk/docs/meade.pdf> accessed 20 October 2019 (hereinafter ‘Meade Report’); however, the R basis is better represented by the zero rating of financial services. The Meade Report notes, at 236, that under the R basis a bank with only financial outputs would have a tax base of $-\bar{R}$, implying that it would be entitled to a credit (and thus a refund) for the tax on its real inputs.

(principally rents and interest), if we think of the accounts of the firm,[59] the profit of the firm is equal to the value of its sales, less the cost of the purchases needed to make the sales (items resold, ingredients, items used up, such as electricity, equipment, etc.) and less wages, the cost of labour. The value added by the firm may be said to be distributable to the shareholders as dividends paid out of profits and to the employees as salaries and wages. Dividends and wages are, therefore, not consideration for services supplied to the firm, but allocations of the value added by the firm and its employees.

On the other side, if we think of all profits as being ultimately earned by individuals, people's resources available to purchase goods and services for consumption all come from present or past earnings of profits and wages.[60] There is a circular relationship in the economy between value added and consumption.[61] In other words, the consistent application of VAT treatment to all supplies of goods and services is necessary not simply to prevent distortion of competition, but also to ensure that the tax is on consumption.

This can be seen in the effect of exemptions. The problem with the exemptions for land and financial services is that many businesses affected by the exemptions, such as banks and insurance companies, provide services to other businesses as well as to consumers. If a bank cannot get credit for the VAT on its inputs, some of that uncredited VAT may be passed on to its customers, but its fully taxable business customers will not be able to get credit for that VAT either. They may also pass part of it on in their prices, which will be subject to VAT – tax on tax. While the crediting system means that all the tax is in principle borne by the consumer, it also means that the amount of tax borne by the consumer is unaffected by the structure of the chain of production. This is no longer the case once there is an exempt transaction in the chain.

59 However, business accounts are calculated on an accrual basis, so that the cost of equipment is not normally deducted at once, but spread over the life of the equipment by deducting a share of it each year as depreciation. In order to make VAT a tax on consumption (and not also partially on investment), it is necessary to calculate profits on a cash flow basis and allow an immediate deduction for the full cost of equipment and other capital items, as well as for inventory (trading stock).

60 This ignores international aspects for now. We could also include future earnings, in so far as an individual is able to borrow for consumption: the loan will be repaid from future earnings. The role of debt in the personal sector as merely resulting in the inter-temporal transfer of consumption helps to explain why debt can be left on one side for now. Debt is also part of the F that is left out of the Meade Report's $R + F$ basis.

61 They are not, however, identical. The portion of wages plus (cash flow) profits that is not spent on consumption is net savings. On the other hand, final spending in the economy (typically measured by gross domestic product (GDP), includes both consumption expenditure and investment expenditure, spending on items to be used in future production. It is a longstanding principle of macroeconomics that in the actual results for a year savings equal investment (subject to the international aspects, as reflected in the balance of payments). In a closed economy savings of individuals are lent to or invested in either other individuals or businesses (whether directly or via financial intermediaries). When the savings go to other individuals, they count as borrowings by the other individuals, so they are netted out of net savings. Thus actual net savings are equal to actual investment.

The justification for the land and financial services exemptions is that, despite these problems, they are the least problematic way of applying VAT in these areas.[62]

1.4. [3.2] Investment vs Management Holding Companies as Based on VAT Principles

The way in which holding companies should be taxed to VAT thus depends on what their role is. The distinction made earlier between investors and management structures is an appropriate one. If a holding company is essentially a means for investors in an enterprise to manage their investments *qua* investments, then it should be treated as a vehicle for private investment that does not carry on economic activity entitling it to VAT credits.[63] This is a private activity of the investors. The fact that it is done in a sophisticated way or using a corporate vehicle should not change the VAT treatment. On the other hand, if the purpose of the holding company is to co-ordinate the activities of the enterprise, to adopt a common business strategy, or at least to adopt a set of strategies that reflect the insights of the controlling shareholders (in a case where the group companies operate in different fields), then the holding company should be seen as part of the enterprise, and should be entitled to VAT credits on its inputs. One would expect that, in the absence of the holding company, a significant part of those inputs would be incurred by the other corporations in the group. It goes against the neutrality of VAT if the structure adopted by the enterprise affects its VAT treatment.

[62] A full explanation of this is beyond the scope of this paper, but in the case of financial services, the essence of the problem is that banks and other financial institutions are in fact providing intermediation services, often remunerated not by fees, but by the spread in interest and other rates that they offer to their different customers (*e.g.* borrowers and depositors). The system of VAT input tax credits makes it necessary to be able to allocate the cost of providing a service among individual transactions.

For example, when a bank takes a deposit from a business, it pays an amount of interest that is implicitly reduced by a fee representing a portion of the amount of the difference (the spread) between the interest rates that it pays on deposits and the (higher) interest rates that it charges on loans (the granting of credit). In principle VAT should be charged on the implicit fee and the business should be able to claim a credit for that VAT as input tax; however, it is impossible as a practical matter to identify the amount of the implicit fee as a portion of the bank's spread on deposit and lending transactions.

Exemption is used as the simplest and least unsatisfactory way of dealing with this problem. A number of alternatives have been discussed in the literature, but they are generally considered to be too expensive, too distortionary or impractical. See *e.g.* Rita de la Feria and Michael Walpole, 'Options for Taxing Financial Supplies in Value Added Tax: EU VAT and Australian GST Models Compared' (2009) 58 ICLQ 897-932 available at <http://dx.doi.org/10.1017/S0020589309001560> accessed 6 December 2015. The cash flow method, at one point considered by the EU and presented in Satya Poddar and Morley English, 'Taxation of Financial Services under a Value-Added Tax: Applying the Cash-Flow Method' (1997) 50 Nat'l Tax J 89-111, is essentially equivalent to the $R + F$ basis: Meade Report at 233.

[63] 'Enterprise' is used here as a neutral term to include a business structured as a group of companies – as in the expression multinational enterprise (MNE).

4. Identifying Holding Companies for VAT Purposes

The challenge is to distinguish between a corporation that is an investor and one that is a managing holding company. The test of 'decisive influence' proposed by the French government in *Cibo* is attractive in principle, but its implementation would not be easy. The French position was that sufficient influence could be presumed to exist where a holding company had a majority interest in the subsidiaries, and offered a number of alternative approaches as well.

> 'Such influence can also be inferred from various features of the legal, financial, administrative and company relationships between the holding and subsidiary companies, such as control of decisions, similarity of business objectives, appointment of management personnel and provision of services in return for a fee.'[64]

In short, this requires the holding company to take a visibly active role in the affairs of the subsidiaries beyond the normal role of a shareholder, even one with a (merely) substantial shareholding.

As a practical matter it would be difficult to determine whether a holding company was taking a sufficient role by that test. What is the line between the interest that a controlling but inactive shareholder (operating through a corporate investment vehicle) would show in the affairs of economically active companies, and the strategic activity and more practical control that would be expected of a managing holding company, and how could this be conveniently assessed for the purposes of VAT – apart from applying an ownership threshold of 50 per cent (or some other appropriate figure), which the ECJ has since *Polysar* said is inadequate? Any more sophisticated test would clearly be challenging to assess, and would be inconsistent with the general aim that VAT should be imposed on the basis of objective factors.[65]

However, it is also necessary to look at the preliminary VAT requirement that the holding company must be engaged in something that constitutes economic activity in the VAT sense, given that the ownership of shares does not by itself amount to the exploitation of intangible property to obtain an income therefrom.[66] The ECJ has long made a connection between the concept of economic activity and the making of supplies that are subject to VAT.[67] Supplies are only subject to VAT when they are made for consideration, but the consideration is also the amount subject to tax. If there is no consideration, there is no basis on which to assess tax. Moreover, there is a need for 'harmonisation of legislation on [VAT], such as will eliminate, as far as possible, factors which may distort conditions of competition',[68] and the examples of

[64] *Cibo* (n 46), Opinion of AG Stix-Hackl, para 9.
[65] See *e.g.* the classic statement in Case C-255/02 *Halifax plc v Customs and Excise Comrs* ECLI:EU:C:2006:121, [2006] ECR I-1609, [2006] Ch 387, [2006] STC 919, Judgement, para 57.
[66] Strictly speaking this is not a problem if the holding company is also engaged in some other economic activity, but the close relation between taxable amount/consideration and economic activity in the ECJ's jurisprudence means that this is not a reliable escape route.
[67] This argument goes back at least to Case 89/81 *Staatssecretaris Van Financiën v Hong Kong Trade Development Council* [1982] ECR 1277, [1983] 1 CMLR 73.
[68] This is the wording now in VAT Directive, recital 4.

economic activity given in what is now VAT Directive, art 9(1), second subparagraph are ones that are typically carried out for reward. 'The context of [what is now VAT Directive, art 9(1)] … and the cohesion of the system clearly prove therefore that a person providing services free of charge in all cases cannot be regarded as a taxable person within the meaning of that article.'[69] This explains why the ECJ in *Cibo* followed its conclusion in *Floridienne* that involvement in management of subsidiaries could be economic activity only when it comprised providing services for a fee.[70]

The test of services for a fee is thus a practical test that reflects the fact that VAT is concerned with imposing tax on transactions. Can it serve the role proposed for the test of sufficient influence in distinguishing between private investment vehicles and managing holding companies? We want to exclude VAT credits in respect of the expenses of the former because, as Advocate General Fennelly commented in *Floridienne*, allowing a credit for input VAT on 'purely private activities' of investors 'would amount to relieving the consumer from the burden of VAT, which would be contrary to a central tenet of the system'.[71]

On the other hand, we want to allow VAT credits in respect of expenses of a managing holding company because it may be able, in an economic sense, to make a significant difference to the performance of its subsidiaries, of the enterprise (without necessarily providing services for a fee). This seems to correspond to the idea of 'decisive influence' and certainly goes beyond 'the mere appointment by a holding company of directors or officers, and … also managers, of a subsidiary' (characterised by Advocate General Fennelly as being just activities of a (private) shareholder).[72] Where management-scale activity makes a difference to the performance of the subsidiaries, it is adding value to the production by the enterprise. This is comparable to the concept of the additional or residual value of adopting the form of the firm that Richard Vann discusses in connection with the concept of the permanent establishment in international (direct) taxation.[73]

The problem with the ECJ's decision in *Cibo* is that it makes it very easy for a holding company to get credit for its input tax simply by charging its subsidiaries for some services. In theory this means that input tax for services received by a fee charging holding company will be creditable even if they are such that otherwise they would look like the sort of services that a private investor would receive in the course of managing a portfolio. Is this, however, a serious concern?

The goal is to have an objective test that is adequate in identifying managing holding companies. The *Cibo* test is tied to the provision of services to subsidiaries of either a managerial or back office nature. While the provision of such services may suggest a management role, the problem is that they are not generating the costs for which credits are being claimed, and it is not clear that the ECJ has imposed requirements on the services that make them much of a proxy for a sufficient management function. On the other hand, after the Court's first two dubious and arguably contradictory

69 *Hong Kong Trade Development* (n 67) para 12.
70 *Cibo* (n 46) para 21, *Floridienne* (n 41) para 19.
71 *Floridienne* (n 41), Opinion of AG Fennelly, para 19.
72 ibid para 26.
73 Richard J. Vann, 'Tax Treaties: The Secret Agent's Secrets' [2006] BTR 345-82.

attempts in *Polysar* and *Sofitam*, the subsequent cases where it has advanced deductibility for holding companies appear to have been ones where the taxpayers were clearly managing holding companies. Where that is the case, it is more important to ensure that VAT is not operating to distort choices of corporate form.

While it is legitimate to exclude private investment activities from the scope of VAT, it is vital for the neutrality of VAT to avoid extending that exclusion to activities of holding companies that are contributing to the value added of business activity. To do so would be to impose a burden on corporate structures that use holding companies. While the benefits of corporate groups and multinational enterprises can be overstated, in general they are adopted because they add value. Economists, lawyers, accountants and sociologists have offered a number of explanations and recipes for the ideal corporate structure, which it is not necessary to discuss here.[74] If VAT on legitimate expenses of an enterprise cannot be credited because they are incurred through the form of a holding company, then VAT becomes a tax on this corporate structure. Because there would be alternative structures that would not bear this burden, it is reasonable to suppose that the extra VAT would to a significant degree be borne through the holding company out of the profits of the enterprise as a whole.

As a practical matter, then, the ECJ appears to have reached a good conclusion in terms of the policy and theory of VAT while using technical reasoning based on the VAT Directive that appears to have little relationship to the theory. References to holding companies with an involvement in management have been converted into the doubtful but easily controlled concept of holding companies providing group services for fees. The creditability of a substantial portion of holding company expenses could also have been denied by being attributed to dividends received from subsidiaries. If dividends received had been treated as consideration for implied services, the services would likely have been exempt as 'transactions in shares' (or perhaps 'transactions concerning payments'). The risk was avoided by treating dividends received as consideration for no transaction and thus radically out of the scope of VAT. The further twist was to treat the holding company expenses as general overheads and so as part of the cost components of the holding company's (remaining and likely taxable) 'products'. Having said that owning shares and managing that ownership is not economic activity, by adding a fee-earning activity, the holding company is able to transform its ownership expenses into expenses of the business as a whole attributable to all of its economic activity, even though the activity to which those expenses are actually attributable is not economic activity.

This reasoning has been successful in achieving a result that has good policy justification, at least in the recent cases that have come before the ECJ, and which preserves the practical link between the conditions of taxability (economic activity)

[74] See *e.g.* Ronald H Coase, 'The Nature of the Firm: Meaning' (1988) 4 JL, Econ & Organization 19, C.W.L. Hill, 'Oliver Williamson and the M-Form Firm: A Critical Review' (1985) 19(3) J Econ Issues 731-51, Nathaniel H. Leff, 'Industrial Organization and Entrepreneurship in the Developing Countries: The Economic Groups' (1978) 26(4) Econ Dev & Cultural Change 661-75, G. Teubner, 'Unitas Multiplex: Corporate Governance in Group Enterprises' in D. Sugarman & G. Teubner (eds), *Regulating Corporate Groups in Europe* (Nomos Verlagsgesellschaft 1990), and Mark Granovetter, 'Business Groups and Social Organization', ch 19 in N. Smelser & Richard Swedberg, *The Handbook of Economic Sociology* (2nd ed, Russell Sage Foundation; Princeton Univ. Press 2005).

and the link to the existence of consideration (as tax base). Nevertheless, there is a risk that it may offer future avoidance opportunities to creative tax advisors. Hopefully, the ECJ would be open to scrutinising further the nature of fee-paying activities that holding companies use to justify their claims to economic activity. If the fee-paying activities were too insignificant, or had no relation to the shareholdings that would justify the claim of the company to be more than an investor in the shares, the Court should be ready, either directly or by applying the anti-abuse doctrines that it has developed, to conclude that the expenses in relation to the shares could not be regarded as overheads of the company's economic activity.[75]

5. Wider Implications

The tale of VAT and holding companies shows how sensitive the tax base can be to apparently technical issues, especially when we look at alternative theoretical models for the tax base. It shows in particular how VAT as a tax on consumption can nonetheless operate as a tax on corporations. This is important because of the unclear incidence of corporate income tax (CIT).

The debate in the literature about the incidence of CIT is generally about the extent to which it is borne by capital versus labour, domestic capital versus international capital, the corporate versus the non-corporate sector and share capital versus debt finance. The evidence suggests that there is some division of the burden between capital and labour, but with a considerable range of estimates dependent on the exact economic features modelled.[76] Some of the earlier literature, including Harberger's classic article from 1962,[77] also discussed the impact on consumers.[78]

The reason for limiting the scope of CIT incidence to capital and labour is that consumption can be considered to be made either by labour or by owners of capital. This means that consideration of the effect of CIT on consumption is redundant. While a part of the incidence may operate through consumer prices, the individuals burdened by those prices will be the individuals supplying labour and capital. Even though the nature of CIT as a tax putatively on capital as a factor of production makes it reasonable to dissect its incidence in terms of the impact on all factors of production,[79] if we want to compare CIT and VAT, it is logical to want to consider incidence in terms of the impact on consumption.

[75] The Court acknowledged in *Marle Participations* (n 56), at paras 41 and 42, that a deduction might be refused to a holding company if it were being claimed for 'fraudulent or abusive ends', but not so as to undermine the right to deduct systematically.
[76] See *e.g.* Jennifer Gravelle, 'Corporate Tax Incidence: Review of General Equilibrium Estimates and Analysis' (2013) 66 Nat'l Tax J 185-214, Kimberly A. Clausing, 'In Search of Corporate Tax Incidence' (2012) 65 Tax L Rev 433.
[77] Arnold C. Harberger, 'The Incidence of the Corporation Income Tax' (1962) 70(3) J Pol Econ 215-40.
[78] Gravelle (n 76) 168 seems to imply that the consensus is that CIT does not fall on consumption, but the explanation here gives a better reflection of the recent discussion.
[79] This approach either ignores land or treats it as part of capital. Further discussion of this point is beyond the scope of this article.

Part of explanation of why this has not been done comes from the structure of consumption. The resources for consumption come from labour earnings plus the returns from capital. Since capital can be considered to be accumulated savings, the stock of capital itself comprises accumulated past earnings of labour and capital. Once we leave out the recursion, we are left with past earnings of labour plus the returns on those accumulations.[80] Current consumption will be out of current labour earnings or current returns to capital, or out of past accumulations.[81] Conversely, current labour and capital earnings will either be consumed currently or consumed in the future. In the latter case they will be augmented by capital returns on the amount saved. A consequence of this is that a tax on consumption will not tax the normal risk-free return on capital, in the sense that, by taxing labour earnings only when consumed, the consumption tax will not reduce the normal return received on saved labour earnings. This does not, however, apply to capital accumulated before the introduction of the tax.

Thus a consumption tax is said to be equivalent to a tax on labour plus a tax on super-normal returns, or economic rents (also referred to as pure profits or inframarginal returns) plus a tax on capital held at the introduction of the tax. This last element is significant in distributional terms, especially between generations.[82] While the distributional aspect can be significant in the case of a shift from taxing income to taxing consumption, its significance in defining consumption as a tax base is overstated. It assumes a consumption tax that is introduced once and then remains in place at a rate that is never reduced. While the last sixty years has shown a history of increasing use of VAT (and other forms of consumption taxation), it would be rash to assume that that trend will never change. A more complete specification would also subtract the tax that will not be levied on capital remaining at the end of the duration of the tax, recognising that the term can only be specified probabilistically. On this basis, ignoring the distributional issues, the core elements of the consumption tax base are labour earnings plus non-normal returns to capital,[83] plus a burden shifted from

[80] Note that this once again leaves out land (or any other primordial capital) as a separate factor of production. For convenience, the discussion will continue this omission.

[81] This leaves borrowing out of account, but this is purely for simplicity.

[82] Liam Ebrill, et al., *The Modern VAT* (International Monetary Fund 2001), 19 and 107.

[83] The reference to 'non-normal returns' is deliberately ambiguous. In principle the return to capital can be partitioned into a risk-free return, risky returns (returns to risk taking) and economic rents. Strictly speaking risky return are a form of market return (reflecting the market for risk), so they are arguably part of normal returns; however, they are, at least in part, investment specific, and it is not clear that their taxation follows the treatment of the risk-free return.

The problem is that the effect of taxation on risky returns has not been well explained, and has only been discussed in limited contexts. There is a developed legal (law and economics) literature (*e.g.* David A Weisbach, 'The (Non)Taxation of Risk' (2004) 58 Tax L Rev 1) that argues that risky returns are not taxed under an income tax (and *a fortiori* not under a consumption tax either), but the results only apply to ideal, proportionate, static versions of the taxes. The limited economic literature on risk and risk taxation suggests that there is no guarantee that even an ideal income tax will not distort risk taking. See *e.g.* Anthony B. Atkinson & Joseph E. Stiglitz, *Lectures on Public Economics* (McGraw-Hill 1980), Louis Kaplow, 'Taxation and Risk Taking: A General Equilibrium Perspective' (1994) 47 Nat'l Tax J 789, and James M. Poterba, 'Taxation, Risk Taking, and Household Portfolio Behavior' in Alan J. Auerbach & Martin Feldstein (eds), *Handbook of Public Economics*, vol 3 (Elsevier

capital accumulated at the end of life of the tax (or following a tax reduction) to capital accumulated prior to the beginning of the tax (or preceding a tax increase).

On this basis it is possible to invert the analysis. In any year the resources available to suppliers of labour and to the owners of capital (abbreviated to 'labour' and 'capital' in the following discussion for convenience) will either be used for consumption (spent) or saved.[84] Savings will either be lent to other individuals (directly or via financial intermediaries), or invested (as equity or debt) in businesses. Savings that remain in the personal sector cancel out, so overall the resources are used either for consumption or investment.[85] A pure consumption tax would be on consumption, while an income tax would fall on consumption plus net investment, that is (gross) investment less depreciation. We could, therefore, analyse a CIT in terms of its incidence on investment versus consumption. This analysis might parallel Harberger's original approach by modelling a corporate sector in comparison to an unincorporated sector, each producing both consumption and investment goods, where investment goods are necessary to future production. The point of this argument is to show that tax incidence on consumption can be meaningfully discussed without the double counting that caused it to be dropped from the usual CIT incidence discussion.

On the other hand, the distinction between CIT and VAT is less great than at first appears. There are three relevant differences between the two tax bases. The first is that VAT, as implemented in nearly all countries with a VAT, is levied on a consumption basis by giving a full immediate deduction for the cost of capital investment.[86] This distinction may be less sharp in practice than it seems, since CIT systems often give at least accelerated depreciation for capital investment, with full deduction or even a subsidy for particularly favoured investments.

The second difference is that CIT gives a deduction for the cost of labour, whereas VAT does not. However, in some ways this is a formal difference. Employees could be included as VAT taxpayers, in which case the VAT falling to be paid by businesses would look a lot more like the CIT apart from the treatment of capital investment, and the CIT plus a payroll tax at the same rate would look very much like a VAT.

The third difference is that VAT is calculated on a destination basis, which includes the value of imports, since they (or what is produced from them) will be consumed within the country, and excludes the value of exports, since they will be consumed in other countries. The converse approach is known as the origin basis. On the other

Science & Technology 2001). The question of how risky returns should properly be dealt with in a general account of taxes on capital is beyond the scope of this article.

[84] Savings can be taken to include negative saving, *i.e.* borrowing to consume out of future earnings.

[85] This parallels the alternative formulations for the calculation of GDP. Leaving out the government and international sectors (as well as land) for convenience of formulation, we have $GDP = C + I = W + P + R + D$, where the variables in the third expression are Wages, Profit, interest (R), and Depreciation. In this formulation wages are the return to labour, profit plus interest are the returns to capital. In the discussion below I will often leave interest out of account for simplicity. The addition of depreciation is necessary because I, investment, is gross investment, *i.e.* net investment plus depreciation.

[86] See the explanation at n 61 above.

hand, CIT normally taxes the income of a corporation whatever the destination of its products and allows the deduction of expenses whatever the origin of the items purchased, which is effectively an origin basis. The fact that the standard CIT structure is designed to tax income from operations abroad principally in the country where it is earned does not detract from this model, although a shift to transfer pricing rules that took account of the country where sales were made (even in the absence of physical activity by the corporation), which is implied by some of the current international debate, would look like a move in the direction of a destination basis.

Alan Tait provides a very helpful classification of ways of levying taxes on value added using two characteristics.[87] A tax on value added may be levied subtractively, as VAT is, on sales less expenses, or it may be levied additively on the components of value added (the entitlements of those who receive the difference of sales – expenses): wages plus profit. It may also be levied indirectly, as VAT is, by calculating the tax as tax on sales less tax on expenses. The alternative would be a direct approach (which has been called an accounts-based VAT or a business transfer tax). The four resulting alternatives are summarised in the table below.

	Direct	Indirect
Subtractive	Tax on (sales – expenses) Accounts-based VAT	Tax on sales – tax on expenses Standard VAT
Additive	Tax on (wages + profits) Additive VAT	Tax on wages + tax on profits Wage tax and profits tax

These four alternatives will be equivalent taxes provided that the bases are calculated comparably. If we are starting from a typical VAT, then profits have to be calculated with full deduction of capital costs (so as to exclude all of gross investment). We should also exclude (income from) exports and include (deny a deduction for the cost of) imports to reflect the destination basis. Conversely, if we start from a wage tax and a profits tax, which with some rearrangement could look like a personal and a corporate income tax (with flow-through taxation for corporations), profits will be calculated with depreciation and a similar approach has to be made on the VAT side with the deduction of expenses on capital goods being converted to depreciation deductions. To reflect the standard income tax origin basis-type treatment of imports and exports, on the VAT side tax would be charged on exports and a credit would be granted on the subtractive side for VAT charged on imports.

This helps to understand the destination-based cash-flow tax (DBCFT) recently promoted by the Republicans in the US House of Representatives as a reform for the US CIT.[88] DBCFT was proposed by Alan J. Auerbach, Michael P. Devereux and Helen Simpson in 2010.[89] The DBCFT would give a full deduction for capital

[87] Alan A. Tait, *Value Added Tax: International Practice and Problems* (International Monetary Fund 1988) 4.
[88] House Republicans Tax Reform Task Force (n 7).
[89] Alan J. Auerbach, Michael P. Devereux and Helen Simpson, 'Taxing Corporate Income' in James Mirrlees et al. (eds), *Dimensions of Tax Design: The Mirrlees Review* (Oxford Univ.

investment, but it also gives a full deduction for domestic wage costs. On the other hand, like a typical VAT, the destination basis means that it taxes all imports (it denies businesses a deduction for the cost of imports), but gives an exemption for exports (it taxes exports at an effective zero rate). The different treatment of domestic and foreign labour is one of the serious criticisms levied against the House Republican's proposal. Interestingly, Auerbach et al. see this as a corporate tax, not a tax on consumption, although they recognise it as having the same effect of not taxing normal returns to capital. One could, however, see it as an additive VAT imposed only on the portion of value added accruing as profits. A complementary tax on labour income (a payroll tax) would effectively complete the additive VAT, and would remove the differential treatment of domestic and foreign labour.

While this combination would be a tax on the cash flow of factors of production, the four-way equivalence for taxes on value added indicates that it should also be a tax on consumption. Whether this would, indeed, be the case depends on a number of factors.

The most important is the imperfections in the taxes. A typical CIT has imperfect loss offsets, which affect its impact on risk taking (and risky returns), a policy driven depreciation schedule, and differential treatment of debt and equity. The last point would not be important if the deductibility of interest and non-deductibility of dividends were matched by appropriately matching treatment of returns from the corporate sector in the personal income tax (PIT) system, and with appropriate international co-ordination. A typical VAT offers something close to full loss offsets and essentially full deduction of capital expenses (subject to the limitations on refunds that can affect loss offsets). However, it exempts interest and other financial returns, resulting, as noted above, in an imperfect *R*-basis tax in the terminology of the Meade Report.[90]

The equivalence of the taxes will also be affected by external factors, such as the role of tax salience. Increasing work has been done on the role that the visibility of taxes can play in determining behavioural responses to them, which can affect their incidence, perhaps not only in the short run. Imperfections in markets also prevent actors from responding in the same way to different taxes. For example, if wages are sticky downwards, or if the capacity to borrow is limited, a direct change in real wages resulting from a change in a wage tax, may yield different economic effects than one resulting from price increases.[91]

Press, 2010) 837-93, 882-90, based on earlier work by Stephen Bond and Michael P. Devereux, 'Cash Flow Taxes in an Open Economy' (2002) *CEPR Discussion Paper* 3401.

[90] See n 58. The *R*-basis taxes net real transactions $R - \bar{R}$, leaving financial transactions out of account, but financial institutions principally make financial transactions, and on the real side may have only expenses. Their VAT position should then be a refund of the tax on $\bar{R}$, but that would appear to fail to tax the value added of financial intermediation provided to the private sector (because it is, usually, only reflected in financial transactions).

[91] Similar considerations arose in the euro debt crises regarding the relative merits of adjustment through wage changes or through currency devaluation, both of which can effect a real wage cut.

6. Conclusion

Fine distinctions in the VAT treatment of holding companies have a profound effect on the effectiveness of VAT in acting as a tax on consumption, rather than as a burden on businesses. That the ECJ has managed to achieve a suitable resolution is has been due less to profound insight into the theoretical nature of VAT, than to skill in using the principles that have been built into and developed from the EU VAT legislation. These principles at heart reflect the theoretical foundations of VAT, but the ECJ has relied on technical and practical aspects of the principles, as expressed in the legislation, that are apparently well removed from those foundations.

In contrast, this treatment of holding companies highlights the dual nature of VAT as a tax on consumption and a tax on value added, and the relationship between those two concepts. This naturally attracts a comparison to CIT with its disputed incidence. Value added, on which VAT is charged, comprises the returns to factors of production as profits and as wages, while consumption together with investment represent the uses to which those returns can be put. On the other side, while CIT has the form of a tax on capital returns, the burden of CIT appears to fall on both capital (profits) and labour (wages). An important difference between the two taxes is that CIT is normally calculated on the basis of a traditional view of profits allocating the cost of capital over time through depreciation schedules. It is therefore interesting to see alternatives to CIT that use a cash-flow (or ‘consumption’) basis in an attempt to alleviate distortions in the allocation of investment. In counterpoint to the subtle differences in the treatment of holding companies yielding a significant difference in the effectiveness of VAT as a tax with (apparently) a simple incidence on consumption, we find a proposed tax that looks a lot like an inverted VAT, while still having a version of the complex incidence of CIT. This contrast suggests that a value added or consumption-based analysis of CIT alternatives and application of the insights from models of CIT incidence could teach much about both taxes.