

Corporate tax system neutrality

The debt and equity distinction from a Dutch perspective

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Abstract

The debt and equity distinction is currently used for several fiscal law applications while it causes many economic distortions. Several countries are already experimenting with more neutral tax system reforms in order to mitigate these economic distortions. Belgium implemented a system where an allowance is given for equity and the Netherlands seek to implement a system restricting the deductibility of group interests. The current differentiation between debt and equity under the Dutch corporate tax law system has yet to be properly discussed by the Dutch parliament. Valid justifications for the distinction therefore remain unclear. Although the distinction does make sense from an economic and civil law perspective, this is not the case from a tax law perspective. The differentiation leads to debt shifting, hard to understand fiscal law and vulnerable, highly leveraged companies. The best reform option for the Netherlands will be a combination of a Comprehensive Business Income Tax system and an Allowance for Corporate Equity system. Such system will improve welfare, remove the debt bias and simplify the Dutch corporate tax system.

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1. Introduction

1.1 Motivation of the current research

The distinction between debt and equity has always been a great topic of discussion. From an economic perspective, the matter of discussion especially concerns the relationship between risks and rewards of the two forms of finance. From a fiscal point of view, the importance of the debt-equity distinction discussion is different. The discussion then concerns the extent to which it is possible to deduct financing costs. The Dutch corporate tax system (Vennootschapsbelasting 1969) clearly differentiates between debt and equity financing costs. Financing costs related to debt are seen as a cost of business and take place in the production stage. Financing costs related to equity are regarded to take place in the distribution stage of a business and are therefore not seen as a cost of business.

The result of this characterization is that financing costs related to equity (dividends) are not deductible, while financing costs related to debt (interest payments) are deductible, leading to favorable treatment for debt financed investments for fiscal purposes. This favorable treatment of debt is called the fiscal bias towards debt. The fiscal debt bias gives businesses the opportunity to erode the tax base by making use of several financing products and capital structures. The gratitude of this issue has become clearer towards the public the last couple of years. For example, in May 2015 *The Economist* published an article called ‘Tax free debt: the great distortion’ regarding the debt bias, referring to it as a subsidy for debt issuance. The article explains that the trick is to disguise equity as debt in order to obtain deductibility of the finance costs.

The distinction between debt and equity has been incorporated in the Dutch corporate tax system for a very long time. Its implications never really experienced any critique or raised any discussion. In hindsight, the lack of critique is actually very surprising. The mentality of business owners was simply very different in the past. If business was booming, why complain? This view was also shared by the government. In 1912, Secretary Kolkman illustrated this point by stating: ‘It would not be in line with the most elementary principles of good taxation policy to, without concrete necessity, abdicate an existing tax system which provides for important and fast growing revenues’ (Kamerstukken II, 1912/1913, p.4) It is hard to trace back the exact moment the Dutch parliament accepted and introduced the debt-equity distinction in its fiscal law system.

Not only the Netherlands distinguishes debt from equity in its corporate tax law. The United States, for example, also differentiate between the two forms of finance. In the United States, the choice to differentiate between debt and equity can be traced back to the 19th century. Parliament allowed for a partial deduction of interests in 1984. This was later overturned by the Supreme Court in 1895. Then, in the period from 1909-1916, partial interest deductibility was re-introduced as a means to help the largely indebted railroad industry. Finally, in 1918, full deductibility of interest was permitted as part of a package to help the companies which were struggling due to the effects of the First World War. Strangely enough, this package has never been reversed ever since, making the equity-debt distinction in the United States inconsistent, to say the least.

Perhaps the answer can be found in the legal principles on which the Dutch corporate tax is based. These principles should provide guidelines regarding the way debt and equity should be treated, since these principles shape the scope of the corporate tax system. The next question then is whether these principles are actually implemented the way they were supposed to.

There are many examples demonstrating the negative consequences of differentiating between debt and equity. The debt bias leads to several economic distortions such as highly leveraged firms and debt shifting. Especially during a crisis, firms with high leverage show great vulnerability and distress. During a crisis, equity bends, while debt breaks. The distinction between debt and equity is also the main source of the current litigation imbroglio in the Dutch corporate tax law. The numerous anti-abuse articles in the Dutch corporate tax law in combination with the difficult to understand case law, have already caused many headaches among fiscal practitioners and legislators. Mainly the large number of different articles restricting the deductibility of interest payments are the cause of the currently incoherent corporate tax law in the Netherlands.

The different interests between businesses and national and international legislators make the debt-equity topic quite interesting. It is of course unrealistic to think that a solution can be found which will fulfill everybody's wishes. Businesses advocate for a low cost of capital in order to enhance their economic position in the international market. Legislators will try to mitigate tax base erosion and enhance the simplicity of the tax system, whilst still improving their business climate in order to attract foreign businesses. The results of implementing a new tax system can for this reason never considered to be perfect, but simply the next best thing.

It is important to first establish whether there is a justification for implementing a neutral tax system. This can be evaluated by examining the issue from both an economic perspective as from a legal perspective. The next step is to find a tax system which will promote neutrality, but is also viable and ideally increases welfare. A neutral tax system does not distort investment decisions for businesses. From an international perspective, a uniform neutral tax system is also welcome, as it promotes a more efficient capital market and leads to less international distortions regarding investment- and financing decisions such as negative spillover effects and profit shifting activities (Redaction NTFR, 2010, p. 4-8). In principle, this tax reform discussion is limited to either levelling up or levelling down of the current tax system. There have been several countries which already experimented with both these solutions including the Netherlands. The Netherlands suggested implementing regulations which would partially restrict the deductions of interest payments between members of the same concern. In Belgium, they are experimenting with a ‘*Notariële Interest Aftrek*’ (NIA) which allows for an allowance for corporate equity. If, however, levelling up or levelling down does not provide a viable solution, a more creative system must be searched for such as an allowance for corporate capital (ACC) or a system which combines both characteristics of levelling up and down.

1.2 Scope and coverage

Governments more and more realize there is more to the debt-equity discussion than priority realized. This thesis will address the debt-equity distinction and will evaluate possible solutions to the problem at hand. The main research question of this thesis is as follows:

Is there a justification for the different treatment regarding debt and equity in the Dutch corporate tax system and what is the best corporate tax system reform option for the Netherlands in order to improve corporate tax system neutrality?

The main research question separates two important elements. The first element addresses the issue whether the debt and equity distinction is relevant for tax purposes. Subsequently, it will be examined how the Dutch tax system needs to be reformed in order to achieve a more neutral viable tax system.

The solution to the main thesis question will be effected by answering the following research questions:

1. Legal Grounds and Developments of the Dutch Corporate and Income Tax System
 - a. What are the legal grounds on which the Dutch corporate tax system is based?
 - b. Have these principles been implemented correctly?
 - c. Do these principles explain the way we treat debt and equity?
 - d. What were the historical tax system developments that led to the current Dutch corporate tax system?
 - e. How did the Dutch corporate tax change over time regarding the treatment of debt and equity transactions?
 - f. What is the current way of treating debt and equity in the current Dutch corporate tax system?
2. Debt and equity neutrality
 - a. Can the distinction between debt and equity be justified from an economic, civil law and tax law point of view?
 - b. What are the advantages of a neutral tax system?
3. Levelling up or down
 - a. What is the essence of levelling up or down?
 - b. What are the advantages and disadvantages of levelling up and down?
 - c. Does any of the two reform options provide for a viable and more neutral tax reform possibility?
 - d. What are the options besides levelling up or down?
 - e. Do these alternative options provide the possible solution to the debt-equity issue?
4. Implementing a new reform system
 - a. What aspects of the Dutch economic environment must be kept in mind when implementing a new tax system?
 - b. What are the effects of the new system on the Dutch economy and its corporate tax law?
5. Conclusion
 - a. What conclusions can be drawn and what is the answer to the research question?
 - b. Which further recommendations can be made?
 - c. Does this thesis provide for any follow-up research?

Some remarks should be made with respect to the scope of this thesis. It is impossible to see corporate income taxation separately from personal income taxation. However, for completeness sake, this thesis will only focus on the taxation of corporations and not at the level of the individual shareholders. Further, not all aspects regarding the debt and equity distinction will be discussed as much into detail as others. It is therefore possible that this thesis touches upon several topics which may ask for additional research, but are outside the scope of this thesis. These topics will be mentioned and elaborated on in the ‘Recommendations for further research’ section of this thesis.

1.3 Structure

Chapter 2 will start with examining the suggested legal grounds upon which the Dutch corporate tax law is based. It will focus on the notion of independency principle and the global balance principle. The principles are first described in debt and are then evaluated to see whether they justify the different treatment regarding debt and equity. Further, the chapter gives an overview of the priority used corporate tax systems of the current Dutch Vennootschapsbelasting 1969. This overview serves as a means of better understanding the way corporations have been taxed over time regarding debt and equity. Finally, this chapter addresses the way debt and equity are currently treated under the Vennootschapsbelasting 1969. Chapter 3 focusses on the question whether the differentiation between debt and equity can be justified. This chapter first introduces an in debt analysis from an economic standpoint, then from a civil law standpoint and finally from a tax law perspective. The second section of this chapter examines the benefits of a neutral tax system. Moreover, the fiscal debt bias is discussed as well as the way a neutral tax system simplifies the current Dutch corporate tax law. Chapter 4 describes two reform options for the Dutch corporate tax law. It describes and evaluates the possibility of leveling up (Comprehensive Business Income Tax) or levelling down (Allowance for Corporate Equity). Chapter 5 examines the possibility of implementing two alternative reform options. While levelling up or levelling down are the most radical reform options, some reform options are less radical. These alternative systems combine characteristics of both levelling up and levelling down. In this chapter, a conclusion will also be given regarding the best possible reform option for the Netherlands. Chapter 6 focusses on the implementation of the suggested reform tax system. It will discuss the necessary characteristics of the Dutch economy and the international position of the Netherlands. This analysis will provide valuable insight into the way the reform system ought to be implemented. The chapter is concluded by evaluating the effects of the new tax system on the Dutch economy and its tax law. Finally, the main conclusions and

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recommendations that can be drawn and made from this thesis will be addressed. Several topics which provide for interesting follow-up research will also be discussed.

2. Legal Grounds and Developments of the Dutch Corporate and Income Tax System

2.1. Legal grounds for the Dutch Corporate Tax

When the tax on corporations was initially introduced in the Netherlands as an income tax (1940), no questions were raised on its actual legal grounds and principles. The corporation tax was designed as an income tax system, which meant that taxes were paid on earned profits and no longer on the distribution of profits. The parliament barely discussed the legal grounds which would justify such a corporation tax. The reason for this was that, at the time, time pressure and acute monetary problems as a result from the ongoing war, forced the parliament to postpone this discussion. Almost three decades later, in 1969, a short discussion took place within the parliamentary meetings. In the end, however, the conclusion was drawn that no matter what the legal ground behind the corporation tax as an income tax would be, the treasury could never do without the tax income. Therefore, the discussion regarding the legal grounds of the tax was deemed irrelevant (Kamerstukken II, 1962/1963, p.1; Kamerstukken II, 1970/1971, p.2; Verburg, 2000, p.12).¹ Available literature also strongly suggests that there is no single and broadly accepted legal ground which accounts for the existence of the Vpb 1969 system as we know it today (Kamerstukken II, 1962/1963, p.2).

For the purpose of this thesis, assessment of the possible legal grounds and principles is important, because the legal grounds directly influence the treatment of debt and equity. The relevant principles which will be discussed are the notion of independency and the goal of global balance. Other suggested legal grounds such as the benefit principle (*'profijtbeginsel'*) and the principle of privileged attainment (*'bevoorrechte verkrijging'*) will not be discussed in this thesis, because it is often argued that these principles can no longer be seen as valid legal grounds for the Dutch corporation tax (De Langen, 1954, p. 38-39; Vleggeert, 2009, p. 29-31). For both principles discussed, the main focus will be on justifiability of the principle and on whether the principle explains the different treatment of debt and equity.

¹ Regarding Kamerstukken II, 1970/1971, page 2 interestingly states that no further arguments will be evaluated regarding the question which legal grounds justify the existence of the Dutch Vennootschapsbelasting.

2.1.1. Notion of independency

The notion of independency entails the concept that companies are no longer just a means for shareholders for doing their business, but that companies are also independent tax subjects which should be taxed accordingly.

The first time the notion of independency was used as a possible legal ground for taxation was with the introduction of the *Bedrijfs- en Beroepsbelasting* 1893. During the parliamentary treatment at the time, it was emphasized that limited liability corporations should be seen as individual legal persons. Based on this view, tax treatment regarding limited liability companies should not take into account the amount of tax paid by its shareholders.

In 1939, *Polak* again deemed the notion of independency (“*zelfstandigheidsgedachte*”) as one of the ground principles of corporate taxation in the Netherlands. His idea was that Limited Liability Companies (LLC) more and more exist for themselves, for conservation and for own expansion, free from its shareholders whom more and more participate in the business in the role of capital providers. This economic independency, this emancipation of the LLC, leads to the assumption of seeing the LLC as an independent tax subject. This means that its profits have to be regarded as its own profits, as a means to satisfy its urge for conservation and expansion, and not as being under temporary control for the persons eventually entitled to the profits (*Polak*, 1940, p. 2-3).

Van Kempen disagrees with the ideas of *Polak* by stating that the LLC’s interests can always be traced back to the combined interests of natural persons. The fact that a company with share capital has its own rights and duties and that the interests of its shareholders can be conflicting with the company’s interests, does not mean that the company’s interest can be detached from its shareholders’ interests. *Van Kempen* explains that the company’s interests are comprised of the interests of all involved parties, as well as its shareholders’ interests, as these interests are shaped by the relation of these parties to the company (*Van Kempen*, 1999, p. 80-81).

Considering the notion of independency as a legal ground for corporate taxation would lead to the conclusion that dividends should be deductible from the company’s profits. *Polak*: “The dividend received by the shareholders should be seen as a cost, just as is the case with bond yields” (*Polak*, 1940, p. 2-3). *Verburg* further states that if the notion of independency can be seen as the legal ground for corporate taxation, non-deductibility of dividends would lead to the conclusion that the notion of independency lacks consistency in its application. On the one hand, the argument is made that the distance between the LLC and its shareholders is growing,

asserting that the LLC possesses independency from its shareholders. On the other hand, emphasis is being laid on the fact that there is a close connection between the LLC and its shareholders, asserting that equal treatment regarding equity and debt capital cannot be the case (Verburg, 2000, p. 9).

Remarkable is the way how *Verburg* applies the notion of independency himself. He advocates deductibility of dividends for the LLC's, but limits this deduction by only allowing the deduction for regular dividends. Apparently he considers the excess profits of the LLC to remain property of the LLC and not as compensation for its shareholders. In my opinion, this application of the notion of independence is inconsistent on its own. I agree with the opinion of *Jan Vleggeert* that the notion of independency does not correspond with regard to the treatment of excess profits mentioned above (Vleggeert, 2009).

Harris does allow deductibility for all dividends in his interpretation of the notion of independency. He argues that the LLC cannot consume for its own good (Harris, 2000, p. 118-119). His theory entails the idea that total income consists out of corporate savings and corporate consumption during a given period. Dividend payments cannot be considered corporate savings. This means that dividends can only be classified as a corporate expense or either as corporate consumption. A very important point made by *Harris* is that a corporation should not be given the capability of consummation. Only individuals are capable of consuming, because, in the end, corporations only exist by fiction. Giving corporations the capability of consummation would stretch one's imagination and is in my personal view incorrect. Corporations only exist by fiction and should not be imputed with characteristics which make it relatable to a natural person.

2.1.2. *Global balance*

During the 1960's, a revision of the Dutch corporate tax system took place. This led to the introduction of the 'Vennootschapsbelasting 1969' (further: Vpb 1969). The revision took place due to a change of view regarding what the main goal of the corporate tax system was ought to be. The revision sought to introduce global balance between the income tax and the corporate tax in the Netherlands.

The term 'global balance' (Dutch: '*globaal evenwicht*') was introduced by *Grapperhaus* and it entails the idea that levies on profits of natural entrepreneurs and corporations should globally be in balance with each other (Kamerstukken II, 1958/1959, p. 16). Further, it is assumed that

the legislator has no preference regarding the legal form of an enterprise, i.e. a natural person or a legal person by fiction (Fiscaal Economisch Dagblad, 1966, p. 85).

At the time, there was indeed a great imbalance regarding natural entrepreneurs and legal corporations in the Dutch Tax system. This imbalance existed because of the way the Dutch income tax system worked. Without a corporate tax, common interest holders (*'a.b-houders'*) that held interest in a BV/NV could accumulate their profits and postpone paying taxes into the indefinite future. In this situation, the profits made on shares would be taxed at a flat-rate tax of Box III for common interest holders, while natural entrepreneurs or natural associated persons (*'medegerechtigde'*) would be confronted with a tax rate of 52% in most cases. The latter group would, by definition, always be worse off than the first group.

At first glance, the concept of global balance sounds as a justifiable ground for corporate taxation. This does not mean that the principle experiences no critique. The main point of critique is not that the concept of a global balance as such is not desirable, but rather that this global balance in fact has never been achieved in the Dutch tax system (Van Dijck, 1983, p. 854-855).

The way the Dutch Vpb treats debt and equity seems to be in line with the global balance principle. Insofar dividends cannot be deducted by the corporation under the Vpb, a correction can be made at the level of the personal income tax in the *'Inkomstenbelasting 2001'* (further: IB 2001). This system ensures that the combined tax burden on dividends within the Vpb 1969 and IB 2001 is equal to the tax burden on interest within the IB 2001.

However, by analyzing the participation exemption, a flaw can be detected regarding the treatment of debt and equity. As specified by the *'Hoge Raad'* (further: HR) in the *Falconsarrest*, the participation exemption serves the purpose of relieving the taxpayer of double taxation in the scenario of participations with a group entity (HR, 2002). The conclusion that can be drawn from this is that the participation exemption is based on the *'ne bis in idem'* principle. Interest that is non-deductible by the debtor should therefore not be taxed again at the creditor under the Vpb 1969. The participation exemption does not provide for such an exemption for interest that was not deductible at the debtor side. It only provides a solution for hybrid debts and low interest debts with a duration of over 10 years.² In this sense, the global balance principle does not explain the different treatment between equity and debt.

² See Article 14(4)(b) jo. 10(1)(d) Vpb 1969

2.1.3. Conclusion

The notion of independency can only be the legal ground for the Dutch corporate tax if all dividends are deductible. In the current Dutch VPB this is not the case, as dividend payments are not taxable at all due to the participation exemption. The only way to see the notion of independence as the legal ground for corporate taxation, without allowing deduction for all dividends, would be to impute the LLC the ability to consume for its own good. In my view this would require too much imagination and would assign human characteristics to the corporate body which should, in any case, not be the intention of any legislator.

The global balance principle does not preclude the different treatment for debt and equity transactions. Insofar dividends cannot be deducted by the corporation under the Vpb 1969, a correction can be made within the personal income tax in the IB 2001. This system ensures that the combined tax burden on dividends within the Vpb 1969 and IB 2001 is equal to the tax burden on interest within the IB 2001.

From the global balance principle follows that profits should only be taxed once (ne bis in idem-principle). Rents that were not deductible for the debtor should therefore not be taxed again at the creditor. Therefore, interest that was not deductible for the debtor should fall under the participation exemption. Since this is only the case for some hybrid debts at the moment, global balance is not present in the Dutch VPB 1969.

Both the notion of independency and the global balance principle provide guidelines for the Dutch corporate tax system. However, it must be noted that neither can be solely seen as the legal ground for implementing corporate taxation. Without full implementation of either one of the principles, the Dutch corporate tax system, as is also the case at the moment, will not be a neutral tax system regarding the treatment of debt and equity.

2.2 Development of the Dutch Corporate and Income Tax System

In the previous section, we found that neither the notion of independency nor the principle of global balance can be seen as the one legal ground for the Dutch corporate tax. The reason for this is that the current corporate tax system does not allow for full implementation of either one of the principles. In this chapter, a short historical overview shall be given of the Dutch corporate tax law and its most important developments regarding the treatment of debt and equity will be discussed. Pinpointing the exact moment the debt-equity distinction was

introduced can provide valuable insight into the justifications from parliament for the debt-equity distinction.

2.2.1. *'Het Patentrecht 1819'*

On May 21 of the year 1819, the ordinance on the right of patent was introduced in the Netherlands (Staatssecretaris, 1819, p. 34). Although preparations regarding the tax law started in 1805, final adjustments were introduced in 1819. This led to the actual implementation of the tax law. The purpose of the 'Patentrecht' (further: PRB 1819) was to tax, by approximation, the profits of each company and profession present in the Netherlands. A patent was nothing more than a license provided by the state that allowed a person to practice a certain profession.

Each profession was categorized into a certain class. This categorization was directly linked to the height of the tax assessment for the practitioners of this certain profession. Another factor determining the height of the tax due was the size of the company and the size of the population of the municipality (Klep, Lansink & van Scheltinga, 1985, p.18).

Mainly due to the fact that the categorization of the professions seemed rather random to many, the PRB 1819 has always been under great scrutiny. One of the opponents of this tax was Alexander Gobel. Alexander Gobel functioned as Secretary of Finance and Secretary of State in the Netherlands during the implementation of the PRB 1819. Gobel laid the foundation of the Unitarian state principle that is still present to this day in the Netherlands (Postma, 2010, p. 56-86). His biggest critique on the PRB was that it was left up to civil servants, whom did not have any comprehension of business and entrepreneurship, to decide how much a person had to pay for his license in order to maintain his business. Also, others saw the law as an impediment on the progress of trade and on industry due to its registration and administration requirements.

A special regime was in place for the limited liability companies ('naamloze vennootschappen'). The base assessment for taxation for public limited liability companies were directly linked to the distribution of profits made by them. The limited liability company's distributions of profit were taxed at 2% under the PRB 1819 (Damsté, 1939, p.2).

In spite of the great deal of critique that was placed on the PRB 1819, it was only abolished 74 years later, in 1893.

2.2.2. 'Bedrijfs- en Beroepsbelasting 1893'

In 1893, Secretary Pierson replaced the 'Patentrecht' by the 'Bedrijfs- en Beroepsbelasting' (further: BB 1893) (Staatssecretaris, 1893). As was the case under the 'Patentrecht' regarding public limited liability companies, the BB 1893 also assessed the tax to be paid on the distribution of profits to the shareholders. Founders, concessionaries, shareholders and others entitled to a share of the profit were also included. Distributions to managers, managing partners, commissionaires and staff were not included. (Streek & Strik, 2012, Vpb.0.0.2.b1.II). The BB 1893 was complemented by the 'Vermogensbelasting 1892' (further: VB 1892) which was introduced one year earlier as a tax on capital. Under the VB 1892, people had to pay 3,125% tax over a fictional 4% yield of their capital (Staatssecretaris, 1892). Together, these two tax laws were referred to as the 'split income tax' ('*gesplitste inkomstenbelasting*').

Under the tax law of the BB 1893, the group of taxable corporate bodies were drastically expanded. Now, next to the limited liability companies and natural persons, also commendatory corporations, insurance companies and foundations performing economic activities would be taxed. Also foreign established companies conducting business in the Netherlands through their related establishments would be seen as taxable persons.

In the original design of the BB 1893, double taxation would be prevented by allowing for a deduction from the distribution of profits of 4% of the capital of the limited liability company because this 4% was already being taxed by the VB 1892 (Kamerstukken II, 1892/1893, p. 12).

However, during the parliamentary treatment it was emphasized that limited liability corporations should be seen as individual legal persons. This was the introduction of the notion of independency in the Dutch tax system. According to *J. Verburg* (2000, p.18), this decision had a crucial influence on the view of how corporations should be taxed. *Verburg*: 'The double taxation regime made place for the notion of independent taxation of corporations.' Based on this view, tax treatment regarding limited liability companies should not take into account the amount of tax paid by its shareholders. Therefore, Secretary Pierson abolished the deduction of 4% in exchange of a great reduction of the tax rate from 4% to 2% (Kamerstukken II, 1892/1893, p. 473-474). This rate would later be amended to 2,5%.

2.2.3. 'Inkomstenbelasting 1914'

Under the 'Inkomstenbelasting 1914' (further: IB 1914), taxation was no longer based on a flat rate, but on true profits earned by natural persons. The taxation of limited liability companies

was no different from taxation of these companies under the BB 1893. Again, the state assessed the tax to be paid on the distribution of profits to the shareholders. Founders, concessionaries, shareholders and other entitled to a share of the profit were also included. Distributions to managers, managing partners, commissionaires and staff were not included (Streek & Strik, 2012, Vpb.0.0.2.b2.II). However, from HR (1918) we can conclude that also creditors could be seen as having shared in the profits of a corporation whenever the rent on a loan could be seen as a taxable distribution of profits insofar this rent was directly correlated with the profits of the debtor.

The VB 1892 continued to exist next to the IB 1914. Therefore, double taxation remained. Tax revenues were booming and despite the still present double taxation issues, there were not any complaints from the corporate world at the time. The reason for this was that for many entrepreneurs, business created more profit than ever. According to Secretary Kolkman: ‘It would not be in line with the most elementary principles of good taxation policy to, without concrete necessity, abdicate an existing tax system which provides for important and fast growing revenues’ (Kamerstukken II, 1912/1913, p.4).

2.2.4. ‘De wet op de Oorlogswinstbelasting 1916’

On 22 June of 1916, Secretary Treub announced the implementation of the ‘*Wet op de Oorlogswinstbelasting*’ (further: OWB 1916) (Staatssecretaris, 1916). This tax was levied besides the still present ‘Inkomstenbelasting 1914’ and ‘Vermogensbelasting 1892’. Subjects of this law was a natural person resident in the Netherlands and a corporation that was established in the Netherlands. The purpose of this tax was to tax profits at an unprecedented high flat rate of 30% due to the World War I (Pfeil, 2013, p. 375).

The OWB 1916 was very complicated to comply to. First, the ‘normal’ profits had to be determined, which were based on previous earnings of the taxpayer. Then, any difference between the ‘normal’ profits and the real profits would be the base for the tax assessments. The difference was seen as a spoil of war and was taxed accordingly unless the taxpayer could prove that the extra profits were not related to the war. Due to the complicated calculations that had to be made, taxable persons and bodies could no longer do without the help of accountants and tax advisors. The tax authorities also noticed they could not levy the tax correctly without controlling the books of the taxpayers. As of that period, due diligence has been very important for taxation purposes.

The OWB 1916 also introduced two new concepts in tax law: vertical loss compensation and a two year carry-back period of these losses (Streek & Strik, 2012, Vpb.0.0.2.b2.III). The OWB 1916 was quickly abolished after the war since the state authorities were afraid they had to retribute a lot of previously collected tax due to the carry-back period.

2.2.5. *'De Dividend- en Tantiëmebelasting 1917'*

Secretary Treub proposed in 1915 to exclude limited liability companies from the 'Inkomstenbelasting 1914'. He saw the *'Dividend- en Tantiëmebelasting'* (further: DTB 1917) as a tax for businesses that would not belong in the income tax. His main argument was that shareholders, by means of collaboration, could earn much higher yields on their invested capital as would be the case if they acted independently (Streek & Strik, 2012, Vpb.0.0.2.b2.IV). From 1917 onwards, limited liability companies were therefore taxed under the DTB 1917 (Staatssecretaris, 1918).

Again, as was the case for limited liability companies before, the DTB 1917 only taxed distributions of profits. New under this law was, however, that also tantièmes would be included in the taxable base. The main motivation behind this was the need for higher tax revenues during and after World War I (Vleggeert, 2009, p. 14). Under the DTB 1917, double taxation remained to exist.

According to art 2 of the first proposal of the tax law, normal and extraordinary distributions to shareholders of profits that would fall under the name of dividends, tantièmes, interests or any other name, would be subject to taxation. When the DTB 1917 was actually introduced, Secretary Treub removed interests from the article. According to Treub, no substantive change was envisaged by the removal of interests. Interests which were only due if the profits allowed them to be paid, would still be taxed under article two (Kamerstukken II, 1916/1917, p. 2363).

At this moment in time, Treub did recognize the possible benefits of taxing true profits instead of distributed profits. However, in his view these advantages did not would not rectify the big disadvantage of having to interfere in business' administrations in order to correctly assess the taxable profits (Kamerstukken II, 1917/1918, p. 101). Treub: 'In the long run, forming large reserves will inevitably result in higher distributions of profits' (Gedrukte stukken 1915/1916, p. 5).

2.2.6. *'Besluit op de Winstbelasting 1940'*

During the period the DTB 1917 was implemented, private business started to realize it was much more beneficial to transform their private business into a limited liability company. To the private person conducting a business, the progressive rate of the IB 1914 applied, whereas under the DTB 1917 a much lower flat rate applied. Also, taxation could be postponed by not distributing any profits to shareholders. An even better result could be achieved whenever the private business was transformed into a limited liability company before the 1st of May of each year, which was the reference date for the IB 1914, because profits which would normally be taxed under IB 1914 would then be left untaxed altogether (Streek & Strik, 2012, Vpb.0.0.2.b2.V).

After many attempts by the state to counter the postponement of profit distribution (Prinsen, 1941, p.18-19), in 1940, Secretary De Geer proposed to introduce a tax on profits. Another reason for this was that De Geer foresaw the upcoming war and knew he needed more tax revenue. He tried to justify the tax on profits by arguing that in effect, no great differences exist between the DTB 1917 and the tax on profits. Only the timing of taxation would change from moment of distribution to the moment of actually earning the profits. Due to the war, no parliamentary discussions were ever held regarding the shift from a tax on the distribution of profits towards a tax on profits. On August 3, 1940 the 'Wet op de Winstbelasting 1940' (further: WW 1940) was implemented (Staatssecretaris, 1940).

Under the WW 1940, limited liability companies, commendatory corporations, cooperative associations and insurance companies established in the Netherlands were subject to tax. Worth mentioning is that foreign companies with an establishment in the Netherlands continued to be taxed according to the IB 1914.

Double taxation still remained to exist. Although, the low tax rate of 10% was not considered too harmful. Distributions of profits were still taxed the same as under the DTB 1917 and losses could be carried forward for a period of 5 years.

2.2.7. *'Besluit op de Vennootschapsbelasting 1942'*

After a period of only 2 years, the WW 1940 was replaced by the German occupiers with the 'Besluit op de Vennootschapsbelasting 1942' (further: BVB 1942) (Staatssecretaris, 1942). In the system of the BVB 1942, corporations were compared to natural persons in the sense that the BVB 1942 for corporations resembled the IB 1914 for natural persons. Nowadays, this is

called the anthropomorphic view. The anthropomorphic view has been heavily criticized. *Brüll* stated that this view does not provide for a viable legal ground of taxation. As with any fiction, attributing human characteristics to a legal person will always be a collision with reality (Brüll, 1964, p. 261).

The BVB 1942 had a progressive rate that ranged from 30% to 55% and the taxable base was based on the systematics of the WW 1940. All profit distributions paid for consideration to a natural or legal person could be deducted from taxable profits as long as the recipient was not related to the tax payer. Distributions to shareholders were not included but were rather seen as withdrawals (*'onttrekkingen'*). After the tax revision in the 1950's, interest deductibility was specifically mentioned in the BVB 1941 under art 12(3) uitvoeringsbesluit IB 1942 (Haberham, 1993, p. 10).

In principle, profit sharing interests were deductible. To prevent tax avoidance by exploitation of this rule, distributions of these interests to shareholders and participants as such were explicitly excluded in Article 14 BVB 1942 (Brief van de Staatssecretaris van Financiën, 1942).

2.2.8. *'Wet op de Vennootschapsbelasting 1969'*

In 1970, the BVB 1942 was replaced by the *'Wet op de Vennootschapsbelasting 1969'* (further: VPB 1969). Since the implementation of the VPB 1969 and the way it is structured today, a lot of changes have been implemented. The first major change is the lower rate of taxation. In the beginning, profits were taxed at a tax rate as high as 48%. This rate has gradually been lowered to the 20% and 25% that is currently used. In order to finance the drop in revenues due to the lower tax rates, amendments made sure that the taxable base of the taxpayer was broadened substantially by restricting the period of allowed carrybacks and carryforwards of losses and introduction of the so called *'objectvrijstelling'* which excluded the deduction of losses of a foreign permanent establishment in the Dutch tax base (Minister van Financiën, 2011, para. 2.2.2.).

Secondary changes had to be made in order to make the VPB 1969 compatible with EU law. Examples of this are the principles defined in the fundamental CJEU case law *Leur-Bloem* and *Bosal* and introduction of the Parent Subsidiary Directive and Merger Directive.

A third source of law amendments find their origin in the wish of the legislator to improve the economic climate of the Netherlands in order to attract foreign investors. Means used to attract

investors were the implementation of the ‘*Innovatiebox*’ and ‘*RDA aftrek*’ (Kamerstukken II, 2009/2010).

Finally, many articles were introduced to combat abuse and aggressive tax planning regarding deduction of interest. One example is the implementation of article 10a VPB in 1997 which combats abusive interest deductions within concerns.

The Vpb 1969 does not specifically state that interest is in principle deductible. It does follow from the ‘*totaalwinstgedachte*’ as defined in article 3.8 Wet IB 2001 and article 8 VPB 1969 (Haberham, 1993, p. 10).

2.3. Current treatment of Debt and Equity in the Dutch Corporate Income Tax

In this section, a short overview of the tax treatment regarding debt and equity under the current Dutch corporate tax will be given. Before looking at the different treatments of debt and equity, it is important to first explain how the distinction between them is made under the current VPB 1969.

2.3.1. Making the distinction

The importance of labelling a capital transaction as debt or equity is very important. The fiscal consequences of labelling a transaction as debt are very different from the fiscal consequences of equity transactions. In short, The Netherlands follows the ‘classic approach’. This means that the payout of dividends is not deductible for tax purposes and that dividends received by shareholders fall under the participation exemption and are therefore not taxed (Keizer & Sunderman, 2012, p. 489).³ Interest payments of a debt transaction are in principle deductible, while received interest payments of a debt transaction are fully taxed.⁴ Another difference lies in the fact that losses due to insolvency can be deducted from taxable profit regarding debt transactions. For equity transactions, these losses cannot be deducted, because they fall under the participation exemption.

The HR has decided that in order to qualify a transaction as debt or equity, the civil law qualification of the transaction has to be followed (HR, 1988). This means that if a transaction is seen as a loan under civil law, this will in principle also be the case for tax purposes. Haberham asserts that the civil presentation is the deciding factor in this regard, meaning that not necessarily the civil qualification is decisive, but rather the way the parties of the transaction

³ Also see article 10.1 sub a/d VPB 1969.

⁴ See article 13.4 Vpb 1969.

present the transaction (Haberham, 1993, p. 131-132 and 159-160). The HR later made clear that the view of Haberham is not correct and that the civil law qualification has to be followed (HR, 2007). Under Dutch civil law, the only criterion for the classification of a transaction as a debt transaction is that there is an obligation for the debtor to repay the principal payment of the loan in the future.⁵

The HR also introduced a few exceptions regarding the main rule mentioned above. A classified loan for civil law purposes will be reclassified as an equity transaction if one of three situations occur (HR, 1988):

1. ‘*Schijnlening*’: Occurs whenever both parties of the transaction try to disguise a debt transaction as an equity transaction for pure fiscal motives.
2. ‘*Bodemlozeputlening*’: Occurs whenever a shareholder provides a loan to a subsidiary while, at the moment the loan is granted, it is known by the shareholder and subsidiary that the loan cannot be paid back in the future.
3. ‘*Deelnemerschapslening*’: Occurs whenever a loan cumulatively meets the following criteria:
 - a. The compensation for the loan is almost completely dependent on profits made by the creditor;
 - b. The debt claim is subordinate to the position of other creditors in the case of insolvency; and
 - c. The maturity date of the loan lies in the indefinite future, meaning that a claim on the principal amount of the agreement can only be made under extreme scenario’s such as liquidation.

The HR also stated in 2012 that there is no room for any other exception besides the three transactions described above (HR, 2012). Therefore, every transaction classified as a loan under civil law that does not fall under the three exceptions will automatically be classified as a debt transaction for fiscal law purposes.

2.3.2. *Treatment of Debt transactions*

Once a transaction is classified as a debt transaction, the transaction can take three further forms under Dutch corporate law: a normal business loan (*zakelijke lening*), a business loan with a non-businesslike interest scheme (*zakelijke lening met onzakelijke vergoeding*) or a non-

⁵ See article 7A:1791 of the Dutch Civil Code.

businesslike loan (*'onzakelijke lening'*). This classification has further consequences for both the debtor and creditor of the transaction.

Loan agreements between unrelated parties are always considered to be businesslike. The question whether a loan or interest scheme can be considered businesslike thus only occurs in the case of a loan agreement between two or more related parties. The HR decided that whenever a debt transaction or compensation scheme fulfills the following criteria, it is considered to be non-businesslike (HR, 2008; HR, 2012):

- The payment is made from a business to a related party, and;
- The payment is made under such conditions and circumstances that the business takes on a debtor risk which an independent creditor would not have agreed upon.

Under such circumstances, it has to be assumed that the business took on this debtor risk with the intention to serve the interests of its shareholder or subsidiary.

It is important to keep in mind that the classification of a transaction as non-businesslike does not trigger a reclassification of the transaction as an equity transaction.

2.3.2.1 Normal Businesslike loan

The normal businesslike is the most straightforward loan for fiscal purposes. In the Vpb 1969, the definition of profit is given in art 8. In sub 1 of that article, a reference is made to chapter 3, section 3.2.2 of IB 2001. In this section, article 3.8 determines that only the net result of the positive and negative cash flows of the business, plus capital contributions and minus capital withdrawals should be taxed. This is called the *'totaalwinstbeginsel'*. According to these articles, the payment of interest is in principle deductible from the taxable profits of the debtor. The interest the creditor receives is taxed due to the application of article 8 sub 1 Vpb 1969. Article 8 sub 1 Vpb 1969 also recognizes that any losses made due to insolvency of the debtor can be deducted from taxable profits of the creditor.

Note that the payment of interest is only in principle deductible from the taxable profits. The Vpb 1969 contains several articles that restrict the deduction of interest payments of taxable profits in certain situations.⁶

⁶ See article 8b (arm's length principle), article 8c, article 10.1 sub d, article 10a-b and article 15ad Vpb 1969.

2.3.2.2 *Business loan with a non-businesslike interest scheme*

This kind of loan can only exist in the situation that the two parties involved are connected (the ‘*gelieerdheid*’ condition of article 8b Vpb 1969).

As explained before, whenever a debt transaction or interest scheme fulfills the following criteria, it is considered to be non-businesslike:

- The payment is made from a business to a related party, and;
- The payment is made under such conditions and circumstances that the business takes on a debtor risk which an independent creditor would not have agreed upon.

An example of such loan would be a normal business loan, issued by a parent company to its subsidiary with interest obligations of 0.1% of the principal amount, while the going market rate of a comparable loan between independent parties would be 6%. The interest payments of 0.1% made by the debtor are deductible. However, a correction needs to take place which fictionally adjusts the interest percentage to the going market rate of 6%. This means that the debtor can deduct the 6% interest payments and that the creditor must add an additional 5.9% of received interests to its taxable profits, despite only having been paid the 0.1% amount.⁷

Article 8 sub 1 Vpb 1969 again recognizes that any losses made due to insolvency of the debtor can be deducted from taxable profits of the creditor. This is no different for the business loan with a non-businesslike interest scheme.

2.3.2.3 *Non-businesslike loans*

This kind of loan can only exist in the situation that the two parties involved are connected (the ‘*gelieerdheid*’ condition of article 8b Vpb 1969).

The loan is assumed to find its origin in the relationship between the debtor and creditor. In the event of a non-businesslike transaction, it is assumed that the creditor took on the additional debtor risk with the intention to serve the interests of its shareholder or subsidiary (HR, 2008). The classification of a loan as a non-businesslike loan in principle does not affect its treatment under the Vpb 1969. This means that the interest payments are deductible for the debtor and are taxed at the creditor side.

⁷ See Article 8b sub 1 Vpb 1969

Strangely enough, the non-businesslike loan does differ in treatment when the debtor becomes insolvent and cannot repay its debt. In this situation, the creditor is not allowed to take any losses regarding the lost debt claim. This treatment corresponds with the treatment of an equity transaction as is explained in the next section. This is strange because the HR explicitly stated that there was no room for another exception besides the *Schijnlening*, *Bodemlozeputlening* and the *Deelnemerschapslening* that would lead to a reclassification of a loan to equity. Equally strange is the fact that from the moment the creditor writes down the debt claim, no contribution of capital takes place at the debtor side, meaning that the debtor is still obligated to repay the full amount of the debt claim.

To conclude, the treatment of non-businesslike loans is very unclear and is not in line with the treatment of debt and equity transactions as such. In my opinion, the HR missed the mark regarding the treatment of non-businesslike loans and should try to provide for clear justifications of this treatment or change the way of treating these loans altogether.

2.3.3. Treatment of Equity transactions

The treatment of equity in the Dutch Vpb 1969 is very straightforward. Again, the *totaalwinstgedachte* from article 8 Vpb 1969 jo. article 3.8 IB 2001 is very important. The definition of the ‘*totaalwinstgedachte*’ implies that only the net result of the positive and negative cash flows of the business plus capital contributions and minus capital withdrawals should be taxed. Capital withdrawals include paying back of capital and distribution of profits of the business (Strik & de Vries, 2011, para. 2.0.4.A.). Any distribution of profits (like dividends) are therefore not part of the *totaalwinst* and cannot be deducted from the taxable profits of the business. This also implies that any exchange losses or share write offs cannot be deducted from the taxable profits of the business.

Compensation for a capital contribution is taxed just like interest payments on the basis of article 8 Vpb 1969. In order to prevent double taxation, the Vpb 1969 provides for a participation exemption for businesses in article 13 Vpb 1969. This article exempts the received dividends from participations. Businesses can make use of this participation exemption if they hold an interest of at least 5% in the business they contributed equity capital to.

3. Debt and Equity Neutrality

The previous chapter gave insight in how the current Dutch corporate tax system came to exist, on which principles it is based and how it currently treats debt and equity transactions. In this chapter, debt and equity neutrality aspects will be investigated. First, the distinction between equity and debt will be reviewed from an economic and legal point of view. Second, the main pro arguments regarding neutral treatment of debt and equity will be examined.

3.1. The distinction between Debt and Equity

In this section, the distinction between debt and equity will be analyzed and reviewed. The distinction between debt and equity will be analyzed from an economical perspective and then from a legal perspective.

3.1.1. Economic rationale

The characteristics that differentiate debt and equity are easy to define. Equity generally involves a permanent contribution of capital in the exchange for participation rights in the control and residual gain of an undertaking. The contributions made are subject to the risk that they will not be repaid in full on the moment the shares are sold. Debt finance is defined as term capital, advanced for a fixed return, which does not lead to participation rights in the control of the undertaking (de Mooij, 2011, p.8). It is often argued that debt and equity are functionally equivalent or are decomposable into comparable capital structure building blocks, indicating that there is no economic difference between the two. This statement will be assessed in the next sections.

3.1.1.1 Participation risk

There are three kinds of risk involved with debt and equity finance. First, whenever an equity investment is made, those whom advance the equity investment bear the risk that their capital will either appreciate or be lost as a direct result of the performance of the undertaking. For debt investments, this risk is not present as the right of return of the principal is not linked to the performance of the undertaking to which the loan is granted. A second form of participation risk is the risk of contingent returns for equity investors. The income derived from dividends is often directly dependent on firm performance. For debt investors, a fixed rate of return is assured. Lastly, equity investors assume some power or control to participate in defining the risk of their investment through being able to define the risk of the undertaking. In this respect, de jure control is relevant. Only a few shareholders that hold shares in public corporations

actually have de facto control. They have the potential to get de facto control by coordinating their de jure rights (Flannigan, 2011, p. 455). In contrast, the debtor does not obtain any controlling powers in the undertaking.⁸ Combining the assessment of these 3 forms of risk participation leads to the conclusion that debt, in contrast with equity investments, does not embrace contingency of performance (Flannigan, 2011, 451-452).

According to *Flannigan* (2011), one form of risk participation should be removed from the equation. By following a definitive approach, the conditions of firm distress should not play any role in defining the border between debt and equity, since the essence of the distinction must be found in its ordinary course application. Firm distress arises from the moment it is known that there is a risk for an undertaking that their operations might be terminated in the foreseeable future. In this situation, liquidation procedures are the only means available for third party investors to recover any initial investment in the distressed undertaking. The risk of liquidation is also called ‘viability risk’.

The viability risk must be removed from the equation because its consequences are common for both equity and debt investments. Both equity and debt claims vitiate whenever firms fail to maintain viability. This holds for dividend payments, interest payments and the recovery of the principal capital investment. Some investors might recover part of their capital due to their higher priority in the liquidation pecking order. However, none of the investors, being debt or equity investors, will receive their scheduled returns for the remainder of the contractual term (Flannigan, 2011, p. 453).

By ignoring the viability risk, a clear border between debt and equity investments can be distinguished. This can be derived from the fact that debt investments do not embrace performance contingency while equity investments do. If we look from the perspective of the firm, by acceptance of contingency by the investor, the undertaking now has gained flexibility for internal and external fluctuations that are affecting its operations. According to *Flannigan* (2011), contribution of capital on contingency defines an equity investment while the foregoing of contingency of performance characterizes a debt investment. In terms of risk exposure, this contingency risk is a very important difference between debt and equity investments.

It is undeniable that differentiation between debt and equity is necessary for businesses regarding their ordinary operational and financial matters. One example would be the matter of

⁸ This is different for the creditor of a loan agreement. Then, the creditor can in fact obtain controlling powers in the debtor.

insolvency tests. Management, future investors and shareholders highly value the knowledge of where the claims on the business originate from (Flannigan, 2011, p. 470). As of 2012, the management of a Dutch firm is also legally obliged to conduct insolvency tests whenever they wish to distribute dividends to their shareholders.⁹ The goal is to prove that the distribution of profits will not lead to insolvency of the business. If they fail to do so, management may become personally liable for another external claims in the case of insolvency.

3.1.1.2 *Debt and equity as functional equivalents*

Some oppose the view that there is a difference between equity and debt from an economic perspective. They argue that debt and equity are functionally equivalent (Hariton, 1994, p. 500-502; MacMillan, 2000, p. 23-25). In this section the functional equivalence argument will be examined.

According to *Alchian and Demsetz* (1975), shareholders should no longer be seen as joint owners but rather as investors. The only difference they recognize is that shareholders are more optimistic than debt holders regarding the future prospects of the undertaking. They only see a difference in the distribution of rewards due to probability (risk) and the contractual terms on which they can invest. In my opinion it is correct that both means of investment serve the main purpose of funding operations. However, the assumption that all forms of risk are equal is in my opinion not valid.¹⁰ For example, investors might have a different risk appetite regarding the degree of risk they are willing to take on. This is reflected in the expected rate of return of an investment. They might also differ in the amount or volume of participation risk they feel comfortable with. The variation of how risk can be bundled materializes this difference. As a means of explaining this statement, the capital irrelevance structure by *Modigliani and Miller* will be used.

In the published theorem by *Modigliani and Miller* it is stated that, in the absence of agency and bankruptcy costs, of asymmetric information, of taxes, market efficiency, etc., firms should be indifferent between the financing possibilities of issuing stock or issuing debt (Modigliani & Miller, 1958, p. 261-297). The value of the firm is not influenced by which capital structure the firm uses. Debt and equity can be substituted by each other since arbitrage will remove any price differences in this fictitious frictionless market. This is called the irrelevance principle.

⁹ See article 2:262, Dutch Civil Code

¹⁰ The article from Bärsch (2012), was the cause for my doubt regarding the economic and functional equivalence of debt and equity.

In a frictionless market, according to this theorem, interchanging between debt and equity finance does not provide for a change in value of the firm. Whenever a shift in risk takes place, a shift within the financial or operational structure of the firm is necessary to neutralize this shift (Flannigan, 2011, p. 464). As mentioned before, the contributors of firm capital, however, will all appeal to different risk appetites. These risk appetites can differ in the degree of risk that one is willing to take (higher or lower rate of return), or in the participation risk of embracing contingency (equity) or forgoing this risk (debt) (Flannigan, 2011). *Modigliani and Miller* recognized this issue and accommodated for it in their model by relaxing their assumptions of a frictionless market one assumption at a time. This led to the foundation of the Tradeoff theory, the Pecking order theory and the Free Cash Flow theory.

First, the Tradeoff theory will be examined. Under this theory, all assumptions regarding the frictionless market remain in place except for the fact that the effect of income taxes are now accounted for. The Tradeoff theory investigates whether debt investments should increase or decrease in the tradeoff between financial distress and tax shielding. Under the initial Tradeoff theory, a firm should be financed a 100% by debt, because income taxes provide for a tax shield and there is no offsetting cost of debt. *Kraus & Litzenberger* (1973) later introduce the logical offsetting cost of debt: the deadweight costs of bankruptcy (Kraus & Litzenberger, 1973, p. 911-922).

Two approaches must be distinguished under the Tradeoff theory. The static-tradeoff theory determines the optimal debt level for a firm in a single period tradeoff between the benefits of the tax shield and the deadweight costs of bankruptcy. *Bradley, Jarrel & Han Kim* (1984) find that an increase in the cost of financial distress leads to a lower optimal debt level for firms. They also find that an increase in the personal income tax rate on equity results in a higher level of optimal debt for firms. Of course, under the static-tradeoff approach, no consideration is made regarding any retained earnings of a company. Also, this approach does not allow the firm to adjust its leverage target over multiple periods. To take account for these considerations, the dynamic-tradeoff theory needs to be examined.

Under the dynamic-tradeoff theory, a firm's optimal level of debt is determined through target adjustment behavior by gradually removing deviations from the target level of leverage over time (Eckbo, 2008, Chapter 12). It states that firms only alter their capital structure if the marginal deadweight costs of bankruptcy are higher than the marginal benefit of the tax shield of debt. This means there must be an optimal range. Inside this range, the amount of leverage

does not change. Outside of the range, where the costs exceed the benefits, the capital structure will be altered.

The static approach indicates that volatility risk (risk of extra costs due to too much leverage) affects the optimal level of leverage for a firm. The dynamic approach further states that outside its optimal range of leverage, a firm will alter its capital structure. In conclusion this means the Tradeoff theory implicitly recognizes the difference between debt and equity regarding volatility risk.

Second, under the Pecking order theory, the assumption of symmetric information is relaxed. The theory states that firms will finance firstly with internal capital, then through debt investors and finally with equity (Myers & Majluf, 1984, p. 187- 221).

Firms will firstly try to finance investments with internal capital. The reason for this is that this form of finance bears the lowest costs compared to the other two options. The only situation where debt and equity will be preferred over internal capital is whenever the firm receives a premium over the price of debt or equity (also called ‘economic rents’) compared to the actual price of debt or equity given the prospected earnings of the firm (Flannigan, 2011, p. 465). The issue of asymmetric information is also not so important when investing with internal capital compared to funds acquired externally. External contributors do not have the necessary information to completely assess the value of a firm they wish to invest in. This issue is more important for the acquisition of a contingent participation (equity) than it is for a fixed participation (debt), leading to a heavier discounted price for equity than for debt claims (Klein, Brien & Peters, 2002, p. 317).

The Pecking order theory thus recognizes a difference between equity and debt in the sense that firms are more inclined to issue debt claims than equity in the case of asymmetric information as a result of the risk assessment of both debt and equity (Myers, 1984, p. 575-592).

Finally, The Free Cash Flow theory relaxes the assumption that agency costs do not exist. It is well known that agents’ goals do not always align with the goals of firm management. Managers might be inclined to use retained earnings of the firm to serve their own needs. The Free Cash Flow theory finds that both fixed and contingent participation can be used as a tool to align manager performance with the goals of the firm (Flannigan, 2011, p. 466). It further recognizes that both equity and debt can be used to align different managerial incentives.

Fixed claims can be used to discipline managers concerning viability risk (Flannigan, 2011). By assuming fixed financial obligations to creditors, free cash in the firm will be reduced. Often, retained earnings are perceived as a 'financial cushion' by managers. By reducing the retained earnings, managers will be subjected to harder thresholds of performance and covenant compliance (Jensen, 1986, p.323-329).

Contingent claims can be used to discipline managers concerning performance risk (Flannigan, 2011, p. 466). Retained earnings would regularly be paid out to managers by giving them contingency of equity claims. The result is that managers are now concerned with performance of the firm, allowing an even tighter margin of error and slack for the managers.

The Free cash flow theory thus indicates that the function of debt and equity differentiates in the event that agency costs are taken into the equation of the '*Modigliani and Miller financial structure theorem*' (Jensen, 1986, p.323-329).

In my opinion, the above shows that the statement that debt and equity are functionally equal is not valid. The Tradeoff theory, Pecking order theory and Free Cash Flow theory show the substantive difference between the choice of embracing contingency participation in the case of equity finance and foregoing contingency but embracing fixed participation in the case of debt finance.

3.1.1.3 Debt and equity as decomposable substitutable capital structure building blocks

The comparable building blocks argument states that it is not tenable to differentiate between fixed and contingent return, because financial equivalences sometimes allow one category of asset to be replicated by using the other category of asset (Warren, 1993, 464-467). In other words, because debt and equity can be substituted for each other through the employment of puts and calls to produce equivalent value, they do not differ in kind in economic terms (Black & Scholes, 1973, p. 637; Flannigan, 2011, p. 467).¹¹ This view is especially popular in modern finance discussions.

This argument relies on the use of external instruments in order to achieve a financial equivalent value. In a way, the risk altering properties of put and call options are used to bridge the different risk exposures of debt and equity (Flannigan, 2011, p. 468). In my opinion, the need for these

¹¹ Warren (1993) explains how this financial equivalence can be achieved by explaining the put-call parity theorem and the dynamic hedging approach.

external instruments thus only confirms that there is indeed a difference in kind between debt and equity. In other words, without the use of these external instruments, debt and equity cannot simply be substituted for each other.

3.1.2. *Legal rationale*

In the previous section, the economic distinction between debt and equity has been examined. The result was that there is indeed an economic rationale for differentiating between debt and equity finance. The question now remains whether it is also always a correct distinction for the context it is used for. Therefore, in this section, it will be discussed whether the different treatment between debt and equity is also justifiable for civil as well as tax law purposes.

3.1.2.1. *The debt and equity differentiation for civil law purposes*

Under Dutch civil law, no clear definition of equity is available. Therefore, the most common used definition of equity is borrowed from the definition of ‘capital’ which is defined in the Dutch Civil Code (further: DCC). According to the DCC, capital can be described in four possible ways¹²:

- Registered capital (*‘maatschappelijk kapitaal’*);
- Issued share capital (*‘geplaatst kapitaal’*);
- Paid-up capital (*‘gestort kapitaal’*); and
- Minimum capital (*‘minimum kapitaal’*)

The amount of registered capital is stated in the bylaws of a business and determines the maximum amount of capital the business can issue without altering its bylaws. The registered capital is divided into shares which can be bought by the shareholders.¹³ The total nominal amount of shares that have been bought are called the issued share capital of the business and the paid-up capital shows to what extent the purchased shares have actually been paid by the shareholders. According to the DCC, shareholders are legally required to pay up at least 25% of the nominal value of the shares they bought in the business.¹⁴ However, it is possible for the business to call up the unpaid amount for the shares by the shareholders. Finally, the minimum capital determines the minimum amount of paid-up and authorized capital of a business.

¹² See article 2:67, paragraph 1 for NV’s and article 2:178, paragraph 1 for BV’s, Dutch Civil Code.

¹³ See article 2:79, paragraph 1 for NV’s and article 2:190 for BV’s, Dutch Civil Code.

¹⁴ See article 2:80, paragraph 1 for NV’s and article 2:191, paragraph 1 for BV’s, Dutch Civil Code.

Before the introduction of the ‘Flex BV’ in the Netherlands, entities were required to have a minimum capital of 18,000 euro’s.¹⁵ As of 2012, the new flexible company law does not require businesses to have a certain amount of minimum capital.

No definition of debt can be found in the DCC. The definition that is used to describe debt is therefore borrowed from the term ‘loan’. The term loan has previously been described as: ‘a capital transaction with an obligation for the debtor to repay the principal payment of the loan in the future’.¹⁶ The repayment requirement is regarded to be the most significant characteristic of debt transactions (HR, 2006).

Now the definitions of debt and equity under the DCC are clear, it is possible to explain why this differentiation is so important. According to Van Strien, debt and equity can be differentiated regarding ownership and control, duration of the capital transfer, remuneration and the risks that are related to the contributed capital (Van Strien, 2007, p. 16).

First, the distinction between debt and equity is important for differentiating between the claim a creditor and shareholder have regarding the business they invested in. A share purchased by a shareholder represents a unit of ownership in that business whereas the creditor of a debt claim in principle receives no controlling ownership in the business.¹⁷ The consequence of this is that a shareholder and creditor have different rights of entitlement with respect to the business where they invested in.

It should be noted that due to the new Flex BV company law, it is now possible for businesses to issue shares that do not provide the shareholder with any voting rights.¹⁸ In this sense, it can be argued that the claims of the creditor and shareholder do not differ as much anymore in the case a business issues shares without voting rights.

The second justification for the differentiation between equity and debt relates to the fact that equity capital is considered to be permanent while debt capital has to be paid back to the creditor. When the debt has to be paid back depends on the agreements made between the debtor and creditor.

¹⁵ See the old article 2:178 sub 3, Dutch Civil Code.

¹⁶ See article 7A:1791, Dutch Civil Code.

¹⁷ It has to be noted that banks and finance companies do have the possibility to obtain ownership of the business’ assets. The legal loan contract grants the lender the right to claim any of the debtor’s assets in the situation the debtor cannot repay its debt on the maturity date of the loan.

¹⁸ See article 2:190, article 2:216 sub 7 and article 2:228 sub 5, Dutch Civil Code.

The difference between debt and equity regarding remuneration claims is important, because the remuneration for equity takes the form of dividend payments to the shareholders while remuneration for debt takes place in the form of interest payments to the creditor. A business is not obligated to pay their shareholders any dividends, while interest payments consisting out of a fixed percentage of the principal of a loan have to be paid to the creditor periodically. Further, the height of the dividends is also contingent on the profits of the business.

The final reason why differentiation between debt and equity is relevant for civil law purposes relates to the different risks involved with both financing options. Equity is by nature riskier than debt in the sense that whenever a business liquidates, shareholders are in a subordinated position compared to creditors regarding any repayment of the initially invested capital. Second, as mentioned before, dividend payments are largely dependent on the profits of a business and are not obligatory while periodical interest payments are. When a firm decides to distribute its profits to its shareholder through dividend payments, the company also has to comply with several legal restrictions.¹⁹

3.1.2.2 The debt and equity differentiation for tax law purposes

So far, it has to be concluded that the differentiation between debt and equity is in fact reasonable from an economic perspective and that the distinction serves several purposes in Dutch civil law. This section will examine whether the distinction also makes sense within the boundaries of Dutch tax law.

First of all, it has to be noted that the implementation of any government policy necessarily introduces new biases in the market economy.²⁰ These biases in turn affect market behavior. The differentiation between debt and equity causes a bias as well. This notion will further be explained in section 3.2.1. Without this bias, the market the business is involved in will determine which value will be awarded to the different risks and returns of debt and equity investments. In other words: The market will price the risk and return differences between

¹⁹ For example, the DCC requires businesses to meet a certain debt-to-equity ratio before any dividend distributions can be made. As of the introduction of the new flexible company law in 2012, directors may face personal liability in the event their business pays out dividends and they could reasonably know in advance that this payout would lead to insolvency (article 2:262, DCC). Directors therefore have to conduct and pass a payout test consisting out of a balancetest and distributiontest (article 2:216 sub 2, DCC).

²⁰ Most forms of bias are the result of a specific tax policy. One example of this would be the excise tax on cigarettes and tobacco. However, other forms of biases are for example explicit and implicit gender discrimination (Stotsky, 1996) and the effect of a tax on savings returns which causes deadweight losses (Feldstein, 2008).

contingent and fixed compensation. Any tax induced bias (sometimes referred to as a 'tax subsidy') towards debt or equity investments will lead to a shift towards one of the two forms of investment.

It is important to understand that the mere existence of a bias does not justify a reform of the tax law of a country. It must be demonstrated that the consequences of the bias causes problems of such great magnitude that it justifies steps to eliminate it. To determine whether this is the case, considerations regarding economic, political and social value must be examined and discussed (Kahn, 1984, p. 1081).

A different question that needs to be answered is whether there is a difference between debt and equity that justifies the differentiation in treatment of their remuneration towards the capital investors (Flannigan, 2011, p. 470). In order to answer this question, a quick review towards the functional equivalence argument must be made. From an economic perspective, there is most definitely a difference in function between debt and equity financing as explained in section 3.1.1. However, from a tax law perspective the functional equivalence argument is applicable.

Businesses employ their capital regardless of where this capital comes from. In other words, the source of capital does not influence the decision of how to invest the capital. Only the output an investment yields is relevant. Where the input comes from is irrelevant. Many corporate finance textbooks consider in this regard the Net Present Value (NPV method) theoretically sound and also suggest the use of this method for maximizing investment decisions (Copeland & Wilson, 1988; Brealey, Marcus & Myers, 2014). The NPV method can be described as the net difference between the present value of cash inflows and cash outflows. A positive NPV value indicates that the earnings outweigh the costs of the investment and calculated the benefit in a present value amount. A present value amount means that all earnings and costs are discounted to the money value amount it would have at the present day. Therefore, the present value amount under the NPV method is the amount an investor would have to be offered today in order to be ambiguous between taking on the investment and receiving the offered present value amount (Garissou, Noreen & Brewer, 2003, 581-583).

Since only the output matters in an investment decision, one unit of debt capital has the same function as one unit of equity capital from the businesses' perspective when management decides to buy, for example, a new IT system or lunchroom.²¹

It is commonly viewed that debt and equity should be treated differently, because interest payments can be seen as a cost of production while dividends are regarded as distributions of profit. The problem with this statement is, however, that it characterizes debt at the production stage and equity at the distribution stage. In section 3.1.1. it is stated that the major difference between debt and equity relates to the reward being based on contingency or being fixed. The question then arises whether contingency makes a contribution any less a cost of production than a contribution in exchange for fixed interest payments.

Income taxes try to tax the increase of financial means attributed to a taxpayer. Evidently, the contractual situation of the taxpayer is important. The fixed earned interest payments that arise from a debt claim do often not represent the same taxable income as volatile profits that arise from an equity stake. But by making this self-evident statement, the debt-equity divide is not employed as a distinctive feature anymore (Schoen, Beuchert, Roesener, Gerten, Haag, Heidenbauer, ... Roeder, 2009, p. 2). Only the financial outcome, irrespective of the qualification of the underlying instruments, should be looked at. Nevertheless, whether a business earns one euro from equity or from debt, it should be taxed the same. Contingency cannot therefore be seen as a distinctive factor. Interest payments and dividends represent the net earnings on invested capital (Chisum, Brudney & Chirelstein, 1973). Disparate tax treatment therefore only results in an arbitrary differentiation of corporate income. It is irrelevant which contractual differences exist between debt and equity instruments. They are not decisive in the defining the definition of corporate income and therefore do not justify the differential treatment between them (Warren, 1974, p. 1603-1608).

It must be noted that the debt equity divide is not completely useless from a tax law perspective. In several procedural matters, the distinction is in fact quite important. For example, a businessman and his creditor will normally not file a joint tax return. This could change if we now swap the creditor with an external person with strong control rights and financial position in the business. In this case, a joint tax assessment with this 'partner' might follow (Schoen et

²¹ It is possible that an investor's decision to invest stems from personal motives. In these situations, maximization of output will likely not be main the goal of the investment and the notion of maximization of output might not hold.

al., 2009, p. 3). Other reasons why the debt-equity divide might be relevant for tax law purposes relate to measurement and timing of income²² and the allocation of income in international situations.²³

From the above I conclude that it is rather arbitrary to allow deductions for interest payments and exempt from income the dividend payments from a tax law perspective. In my opinion, the distinction between debt and equity for that purpose should be eliminated. I also recognize that the distinction is not completely useless. Tax policy addressing the distinction therefore requires a lot of attention. Reforming a tax regime that incorporated the distinction for nearly two centuries would encounter many technical issues. Re-schooling costs would play a considerable role and current tax planning strategies of companies would be disrupted. Feasibility therefore remains the biggest hurdle in implementing such a neutral tax (Flannigan, 2011, p. 470-472).

The question now remains whether both kinds of contributions should be seen as production inputs or as distributions of profits. In the first scenario, interest and dividend payments should be deductible from taxable income, because they are a cost of production for the business. In the second scenario, both interest payments and dividend payments should not affect taxable income, because they are seen as a distribution of profits. This discussion will be continued in Chapter 4.

3.2. Advantages of a Neutral Tax System

In this section, arguments that support the implementation of neutral treatment between debt and equity are discussed.

This section will first examine the effect of corporate tax policies on the user cost of capital and explain whether this leads to a bias towards one form of financing. Further, the consequences of a tax policy which implies a debt bias will be discussed. This discussion will entail the issue of debt shifting, the effects of higher debt-equity ratios and the issuance of hybrid instruments. Hybrid instruments play a big role in the international base erosion and profit shifting

²² Most jurisdictions measure income based on the accrual method while privately-held income from debt is measured according to the cash method (Ault & Arnold, 2004, p. 243).

²³ Return on equity is most often taxed where in the country where the business is carried on. Return on debt is normally taxed in the resident state of the holder of the debt instrument. For a more elaborated discussion regarding this topic, see (Schoen et al., 2009, p. 6-8)

problematics. Finally, implementing a neutral tax system could remove the litigation imbroglio concerning the deductibility of interest.

3.2.1. The Bias towards Debt Finance

This section will first explain the concept of the bias towards debt finance, it will further also examine the consequences of this debt bias.

3.2.1.1. The Debt Bias Explained

Economists often refer to the user cost of capital when analyzing the effects of tax policies on corporate investment. As defined by the OECD, the user cost of capital can be described as the unit cost for the use of a capital asset for one period (OECD, 2009). In other words: the price for employing or obtaining one unit of capital services. A corporate income tax in a closed economy which allows for full deductions for true economic depreciation and, on the corporate level, the opportunity cost of finance, leaves the user cost of capital unchanged (King, 1975, p. 271-279; King, Fullerton & Alworth, 1984).²⁴ Taking on investments earning only the rate of return needed to cover for the depreciation and finance costs would not lead to paying any taxes because there is simply no taxable amount left after these costs. Only returns exceeding this minimum required rate of return would be taxed (Bond, 2000, p.4).

If these returns are compared with accounting profits, it can be seen that accounting profits generally deduct interest payments associated with debt financing. On the other hand, no adjustment is made for the opportunity cost of finance associated with investments financed by equity. The opportunity cost of financing an investment with equity entails the deductible interest earnings the investor could have earned if the shareholders' wealth had been invested through debt elsewhere. In other words: the additional cost of capital of investments financed by equity, compared to the cost of capital of investments financed by debt, are the deductible interest payments which provide for a tax shield that could not have been earned through an equity investment.

Implementing a tax system which does allow a deduction for depreciation, but not for the costs of finance (for both debt and equity), or does not give a full deduction for depreciation, will increase the cost of capital (King, 1975, p. 271-279). Investments earning the minimum return

²⁴ As pointed out by Claus, Gemmel, Harding, & White (2010), such a deduction in an open market would only prevent distortions if the deduction would take place on the shareholder level. The main argument for this is that in an open market, the location decisions of international companies earning mobile rents would be affected.

required to cover depreciation and finance costs would become unviable with the implementation of such a tax.

By implementing such tax system, market participants will alter their decisions regarding investment. In the situation described above, where the minimum return is earned to cover depreciation and finance costs, the tax system creates distortions which can easily lead to welfare losses. If the firm cannot take on any more debt, the investment would become unprofitable, because financing the investment through equity is not an option due to the higher cost of capital. The firm will have to forego a viable investment opportunity due to the debt bias of the tax system.

Modern corporate income tax bases are computed very much like the accounting measures of profit: interest payments are deductible against income in the computation of taxable profits in all the OECD countries, while, besides Belgium, Austria and Brazil, there is no comparable deduction for the opportunity cost of using equity finance (OECD, 2015). The tendency introduced by these modern corporate tax bases lead to higher user cost of capital for investments that are financed through retained earnings while there are only limited effects on the costs of capital for investment that is financed by borrowing. This advantage regarding debt finance is called the bias towards debt finance.

Studies reveal that corporate debt ratios indeed rise due to the tax advantage of debt (De Mooij, 2011, p.8). The consensus estimate 267 tax elasticities from over 19 different studies to perform a meta-analysis. *De Mooij* measured that the impact of the corporate income tax rate on the debt-asset ratio of firms, lies between 0.17 and 0.28 (De Mooij, 2011a, p. 21-22). This means that a decrease of 5% of the statutory tax rate would result in a decline of 0.85% and 1.4% of companies' debt-asset ratios. Although this result is significant, it is not as big as might have been expected. *De Mooij* also finds that elasticities have become significantly higher over the past few years. For instance, for 2011 data the analysis predicts an impact that is 1,5 times as large as the average found in the literature based on the period between 1998 and 2010.

Before discussing the negative consequences of the debt bias in tax systems, it must be duly noted that debt in itself serves many economic functions. A firm that does not have sufficient cash at the moment but has good prospects can simply borrow money and repay its debt back again the next day. Also, managers particularly like the fact that by lending money, they do not lose control of their firm as would be the case with share issues. Wealthy private persons, whom

earn more money than they wish to spend can also lend money to those whose spending exceed their normal income.

3.2.1.2 *Consequences of the debt-bias*

In the published theorem by *Modigliani and Miller* it is stated that, in the absence of agency and bankruptcy costs, of asymmetric information, of taxes, market efficiency, etc., firms should be indifferent between the financing possibilities of issuing stock or issuing debt (Modigliani & Miller, 1958). There is, however, no logical amount of debt (De Mooij, 2011, p. 11).²⁵ What is considered debt for one firm, is considered an asset for another firm. This means that in the end, global debt should net out to zero with the associated assets. When some of the assumptions mentioned above are relaxed, like the addition of levying taxes, firms will deviate from the rule proposed by *Modigliani and Miller*. The value of an unleveraged firm is no longer equal to the value of a leveraged firm. Due to the tax shield provided by the deductibility of interest payments, firms could theoretically maximize their value by being financed by 100% debt (Fatica, Hemmelgarn & Nicodeme, 2013, p.3). In studies performed by the International Monetary Fund and Mckinsey Global Institute, the popularity of debt financing continues to significantly increase over time (International Monetary Fund, 2015, Chapter 3; Dobbs, Woetzel & Mutafchieva, 2015). Of course, not all of this growth can be attributed to the tax bias towards debt finance, but it does play a significant role.²⁶

Numerous research has shown that high private debt levels can be associated with slower GDP growth and that high debt levels increase the risk of a financial crisis (Reinhart, Reinhart & Rogoff, 2012). Especially during a crisis, the fragility of debt is exposed. In contrast, equity or shares provide sustainability during a recession. When things go wrong, dividend payments can be cut or not be paid towards equity holders while insolvability to repay debt might trigger bankruptcy. Generally speaking, banks tend to restrict their credit supply during a crisis. The debt bias could lead to liquidity constraints in the sense that a neutral tax system would make financial as well as non-financial companies less vulnerable to short-term restrictions of credit supply by the banks (Fatica et al., 2013, p. 5). Debt is also time bound. Meaning that it has to be refinanced after the maturity date. This is not the case for equity. In a financial crisis, equity bends, while debt breaks. An example of this is the 1997-2000 dot-com stock market crash.

²⁵ Studies do try to find the optimal debt level for firms. See, for example, Bolton & Scharfstein (1996).

²⁶ As mentioned in the working paper by the European Commission (2012): bankruptcy costs, agency costs and signaling effects also contribute towards more leveraged corporations.

With almost double the losses of the 2007-2010 crisis, no credit crunch occurred mainly due to the lower leveraged firms at the time.

Besides issues arising with highly leveraged firms during a crisis, high debt levels also lead to several welfare costs for society. Studies estimate that the welfare cost of debt financing is between 0.08% (Weichenreider & Klautke, 2008, p. 17) up to 0.25% (Gordon, 2010, p. 152-173) of national GDP. According to *de Mooij*, the real welfare costs of debt financing will be even higher. He points out that other negative externalities and other pre-existing distortions in the financial sector are not accounted for in the calculation and that the tax arbitrage effects of the debt bias leading to substantial administrative and compliance costs were also no part of the computation of these estimates (De Mooij, 2011, p. 12-14).

During a crisis, high debt levels can also lower confidence for managers. They will generally want to deleverage their firm. The result is a cut in spending and investments. This way, private debt will actually shift towards public debt, because of lower direct and indirect tax revenues for governments, only adding to the burden of the crisis.

Tax favored borrowing may also cause firms to take on more debt by taking greater risks. Investments which are uneconomic before taxes, become marginally viable after taxes due to the use of hybrid mismatches (OECD, 2012, p.11). More on this will be explained in the following sections.

To conclude, the debt bias stimulates firms to take on more debt due to its lower user cost of capital than equity. Simultaneously, higher levels of debt introduce great welfare losses and vulnerability in the event of a crisis or recession. A neutral tax system stimulates firms to lower their leverage in order to safeguard themselves for times when the economy is not doing well. In the situation of an economic crisis, the market can recover much faster. Also, the welfare costs due to high debt levels would be significantly lower.

Debt shifting

Related to the problem described above is the issue of debt shifting by international companies. Earlier, the possibility of a tax shield through deductibility of interest payments has been explained. Two other forms of tax shields are internal and external debt shifting. Debt shifting aims at receiving a deduction for interest payments in a country where the marginal tax rate is higher than the marginal tax rate where the interest is being taxed. On a group level, this leads to a lower overall tax burden. The different forms of debt shifting will be discussed below.

External debt shifting arises when a parent companies issues external debt and balances this debt over its affiliated subsidiaries located in different countries. A review on the economic literature regarding this issue in the U.S., Canada, Germany and the EU shows that this literature corresponds with the tax minimization objectives of firms which use their financial structures and interest payment flows across borders (Laeven, Huizinga & Nicodème, 2007, p. 13-16). According to the study performed by *Laeven, Huizinga & Nicodème*, with data taken from 32 EU countries between 1994-2003, an increase in the statutory tax rate of 10% leads to an increase in the leverage of the firms as a group as of 1,8%. The debt is balanced between two affiliates of equal size. In the country of the affiliated company where the rise of 10% in the statutory rate took place, leverage of the affiliated company rises with 2,4%. Leverage in the affiliated company in the other country decreases by 0,6%, indicating debt shifting.

Internal debt shifting occurs when group companies borrow from each other instead of from an external source. In comparison with external debt shifting, the tax elasticity of internal borrowing is higher than borrowing from an external company. *Desai, Foley & Hines* find that for internal borrowing, the elasticity is around 0,35 while for external borrowing, the elasticity is around 0.19 (Desai, Foley & Hines, 2014, p. 2451-2487). This means that an increase in the statutory tax rate in one of the affiliated firms' countries stimulates internal debt shifting more than external debt shifting. *Egger, Eggert, Keuschnigg & Winner* further find that on average, foreign owned firms show higher debt ratios than its domestically owned counterparts in the host country. Also, a positive correlation exists with the height of the debt ratio and the statutory tax rate of the host country. Combining these statements leads to the conclusion that internal debt shifting takes place whenever the statutory tax rate in the host country increases (Egger, Eggert, Keuschnigg & Winner, 2010, p. 96-107).

Both forms of debt shifting find their origin in the tax bias towards debt finance. Tax shields have negative consequences such as international tax revenue losses and distortion of economic competitiveness and decision making. Although introducing a uniform neutral tax system would not necessarily solve the problem of debt shifting, it will diminish its importance due to the lower debt ratio's firms are willing to take on.

Issuance of new hybrid instruments

Hybrid instruments share some characteristics of debt and some of equity instruments. Equity is characterized by their permanent contribution of funds, for which no obligation to repay the principal amount is present. Dividend/Coupon payouts and loss abortion are also not obligatory

for the issuer. Debt on the other hand, is a term commitment of funds that does contain the obligation to repay the principal and coupon amounts. Debt transactions also contain a priority right to recover the initial investment in the event of insolvency (Mackenzie, 2006, p. 32). Preference shares, for example, do pay a fixed rate of return (characteristic of a debt instrument), but do not lead to entitlement of any return to the holder if the issuer does not have enough resources (characteristic of an equity instrument). Other examples of hybrid instruments are convertible bonds, junk bonds, subordinated debt, preference shares, indexed securities and warrants (Harris, 2014, p. 8-12). In a way, hybrid instruments blur the distinction between debt and equity instruments.

With the use of a hybrid instrument, a situation can be arranged where the same instrument leads to a deduction in one country, while no profit is included in the other country. This different qualification is possible due to the variation on the rules that demarcate debt and equity internationally (Johannesen, 2014, p. 40-41).

Countries apply different approaches in determining whether a financial instrument should be considered as equity or debt. Under the formal approach, the criteria of the financial instrument are decisive. Under the substance-over-form approach, the distinction is made on a case-by-case basis, reviewing the true substance of the instrument and thus looking further than just the criteria that would consider a transaction debt or equity (Schoen et al., 2009, p. 88-89). In the Netherlands, a substance-over-form approach is used. A consequence of this approach is that interest paid on profit sharing loans do not lead to deductible interest payments because they will be classified as equity.

The international classification mismatches have several negative consequences for governments and smaller domestic businesses. First, the mismatches lead to a loss of revenue for the states involved. Although it is often not necessarily clear which states loses the tax revenue, the overall tax revenue earned by the involved countries is less in total. Indirectly, the taxpayer even further erodes the tax base of its residence country by being able to deduct advice costs for devising and implementing these arrangements.

Hybrid mismatches also distort competition by rendering a competitive advantage for big wealthy corporations which operate in cross-border situations. Small and medium sized national companies often do not have the funds or expertise available to them in order to make use of the hybrid mismatch opportunities.

A third consequence of the use of hybrid instruments is that they distort import and export neutrality. By making use of a hybrid mismatch, a cross-border investment will be more beneficial than an equivalent domestic investment, thus affecting capital export neutrality. Analogously, capital import neutrality is affected because the cross-border investment is more favorable than the competing local investor in the target country (OECD, 2012, p. 12).

The existence of hybrid instruments which create mismatches, generate significant global policy issues. They lead to tax revenue losses, distort the international economic market and reduce international transparency and accountability of corporate financing policies.

It must be noted that there are definitely sound reasons to make use of hybrid instruments besides exploiting their possible tax mismatch properties. See, for example, convertible bonds. A convertible bond can be used to mitigate the volatility risk of an equity investment. A convertible bond is an issuance of debt which can be converted to a company's common stock at any preferable time. Therefore, convertible bonds resemble a sort of call option for the investor.²⁷ If the stock price goes down, the call option will not be exercised and the payments of fixed interest will continue. If the stock price of the company goes up, it is possible to convert the bond into stock. The option will normally only be exercised if the stock price is above the strike price of the bond, leading to a gain for the investor. A disadvantage of convertible bonds is that their interest rate normally is lower than the going rates for non-convertibles. The difference in rate resembles the opportunity cost of the gained security by having the option to convert at any given time (Berk & Demarzo, 2014, p. 814-816).

A hot topic in the world of tax at the moment is the BEPS action plan. This action plan aims to address situations where profits are perceived as geographically split from the activities and focusses on double non-taxation through mismatches between the interactions of domestic tax systems. For the issue of hybrid instruments, action 2 of the BEPS action plan was introduced (OECD, 2014, para. 18). Action point 2 is seen as one of the most important action points and still many questions are present on how to implement it. A globally neutral tax system could definitely contribute to greater international transparency and perhaps even offer solutions to this issue.

²⁷ A call option is written by the company itself on existing stock. For a convertible bond, the company writes the option on new stock. This kind of call option is referred to as a warrant.

3.2.2. *Simplifying the Tax System*

A neutral tax system reform can benefit the Dutch corporate tax system greatly. Reason for this is that the Dutch VPB 1969 is known for its difficult to understand and often contradicting case law as previously explained in section 2.3.1.

Whenever the non-tax consequences are slight, as is often the case for closely held enterprises, companies and its investors have a strong incentive to characterize any investment as a debt investment. By doing this, companies can make use of the debt tax shield the Dutch tax law provides them and avoid double taxation of paying taxes at the corporate and investor level (Warren, 1974, p. 1605-1606). Companies issued many new hybrid financial instruments in order to abuse this benefit. The HR was therefore forced to introduce new case law in order to counteract this abuse. By eliminating the distinction between debt and equity, this litigation imbroglio could be avoided.

Further, the choice between levelling up or down (further explained in chapter 4) affects the way the tax law articles itself can be simplified. In the situation where interest payments can be considered as a distribution of profits, several hard to understand non-allowance of interest deduction article can be removed from the tax law.²⁸ The reason for this is that these payments are now exempt due to the participation exemption of article 13 VPB 1969. The 5% interest requirement of article 13 VPB 1969 would have to be removed in order to allow creditors to make use of the exemption as well. Another result would be that the Dutch ‘*Dividendbelasting*’ could be abolished.²⁹ In the alternative approach, where dividend payments are deductible from taxable income, some difficult articles regarding non-allowance of interest deductions could be removed.³⁰

²⁸ See article 8b (arm’s length principle), article 8c, article 10.1 sub d, article 10a-b and article 15ad Vpb 1969.

²⁹ Jan Vleggeert also introduces an alternative for the abolishment of the *Dividendbelasting*. He suggests imposing a withholding tax on interests instead. See Vleggeert (2009, p. 58-59)

³⁰ Article 10.1 sub d and article 10a.1 sub a could be removed from the VPB 1969. For a more extensive discussion regarding this, see Vleggeert (2009, p. 41-43)

4. The Essence of Levelling up or Levelling down

Interest payments are currently seen as a cost of production while dividend payments are seen as a distribution of profits. The reason for this is that the interest payments supposedly take place in the production or input stage of the business while dividends payments seem to take place in the distribution of profits stage of the business. Implementing a neutral tax system would imply either treating both interest and dividend payments as if they both take place in the production stage or as if they both take place in the distribution of profits stage. The first scenario implies that interest and dividend payments should both be deductible from taxable income, because they are seen as a cost of production for the business. The second scenario implies that both interest payments and dividend payments should not affect taxable income, because they are seen as a distribution of profits.

In principle, these two scenarios translate into two more radical tax systems: An Allowance for Corporate Equity (further: ACE) and a Comprehensive Business Income Tax (further: CBIT). This chapter will discuss these systems and examines the relevant properties of both systems.

4.1. CBIT

In 1992, the US Department of Treasury published a report named: *‘Integration of the individual and corporate tax systems – Taxing business income once’*. As is the case in the Netherlands, the US also has a classical tax system in place. The report tried to diminish the distortions that inherently arise with the implementation of a classical tax system such as double taxation (taxation at the personal and corporate level), the bias towards debt finance and the incentive for businesses not to distribute profits (Vleggeert, 2009, p. 55-60). One of the proposed tax systems described in the report was the CBIT. The CBIT would replace the corporate tax and would be implemented as a general business tax. This means that it would not only apply to corporations but also to natural persons conducting a business. Under the proposal, no capital will be taxed at the personal income level.

The CBIT makes a distinction between CBIT entities and non-CBIT entities. Besides small firms, mostly all other firms fall under the CBIT entity group. This CBIT group will be denied interest deductibility (De Mooij & Devereux, 2009, p. 16). The CBIT thus implies that both interest and dividend payments take place at the distribution of profits stage of the business. Interest or dividends received from another CBIT entity will be exempt from taxation, while interest or dividend received from non-CBIT entities will be subject to tax. From the business’ perspective, it will therefore be relevant to keep an administration in order to know which

profits are taxed and which are not. Businesses must have this administration in place before they decide to pay out any dividends or interest payments.

For example, interests paid outside the ordinary course of business (e.g. interests from households) are deductible for the debtor and are taxed at the creditor side. Businesses therefore need to differentiate between this taxed non-CBIT debt and its exempt CBIT debt (e.g. interests from a bank). Interests received from foreign businesses is classified as non-CBIT debt under the CBIT system and is taxed. However, an exemption or credit can be applied if this interest comes from another CBIT-entity. This is relevant in the event other countries also adopt a CBIT system (De Mooij & Devereux, 2009, p. 16).

The CBIT proposal expands the tax base, resulting in greater corporate tax revenues. Many recent policies advocate in favor for the implementation of a CBIT, because the broader tax base allows for a possible reduction in the tax rate. The rationale behind this is that it is conceived that profit-shifting, relocation decisions and investment decisions are in some way linked to corporate tax rates (Fatica et al., 2013, p. 12). Studies indeed recognize the negative correlation between statutory tax rates and profit shifting, meaning that implementation of a CBIT system would improve the investment environment of the country.³¹ However, studies also recognize that investment and relocation decisions of a business are more linked with effective marginal tax rates and effective average tax rates than with statutory tax rates.³² This means that investment and location decisions also take the elements of the tax base into account and are not solely made on the assessment of the lowest available statutory tax rate. A CBIT system also increases the cost of capital regarding debt investments, because businesses can no longer profit from the debt tax shield. Evidently, this leads to lower debt financed investments. This effect is opposite for the ACE system as will explained in the next section.

An issue with the proposed CBIT system is that it carries some difficulties in how to treat pre-existing debt (debt present before implementation of the CBIT system) and how to treat the capital gains made from selling equity by the shareholders. A possible exemption for these capital gains might create opportunities for tax avoidance (Shaviro, 2011).

³¹ For a more detailed discussion regarding the relationship between statutory tax rates and profit shifting activities, see Dharmapala & Riedel (2013, p. 95-107); Weichenrieder (2008) and Dischinger (2007)

³² An effective average tax rate is relevant for making location decisions since it provides information on the impact of taxation by measuring the effective tax burden on profitable investments. The effective marginal tax rate is a theoretical tax rate which is used to assess the scale of an investment. This means that it describes the case where the after-tax profit compared to an alternative investment is zero. For a more detailed discussion regarding these different tax rates, see Bachmann & Baumann (2013)

Assuming government policy strives to maintain the same amount of corporate tax revenues it earned before implementation of a CBIT, the broader tax base allows for a reduction in the corporate tax rate. This lower tax rate, in contrast to debt investments, decreases the cost of capital for equity financed investments. Due to the lower tax rates, governments therefore may attract mobile (company-specific) economic rents and obtain macroeconomic benefits (OECD, 2016). Economic rents in this regard can be described as above-normal investment returns.

According to *Claus, Gemmel, Harding, & White* (2010, Chapter 5), the effect on investments due to implementation of a CBIT might be ambiguous. The cost of capital regarding debt financed investments rises while the cost of capital regarding equity financed investments decreases. This in turn will lead to a decrease of debt financed investments and an expansion of equity financed investments (Sørensen, 2007, p. 172-228). *Bond* (2000) adds that the benefits from a lower tax rate under a CBIT system are very likely to outweigh the costs of an overall higher cost of capital.

Real world applications of a CBIT system

So far, there are no real world applications of CBIT regimes. Countries do recognize the benefits of neutral treatment between debt and equity, but none of them has yet conceded to the idea of a 100% neutral CBIT regime. There are plenty of examples available of countries implementing limited interest deductibility regimes. An example in this regard may involve thin-capitalization regulations, which were implemented by approximately 60% of EU member states in 2005 (Buettner, Overesch, Schreiber & Wamser, 2012). It is found that these thin-capitalization regulations are effective in decreasing the debt-asset ratios of firms. The downside of the regulations is that they also tend to decrease investments (Buettner et al., 2012).

In 1997, the Netherlands implemented a CBIT-like regime for holdings. The regime allowed for 80% of income received by Dutch holdings to be labelled as ‘provisions’. These provisions were left untaxed. This regime was phased out in 2010 as it was placed on the list of harmful tax practices by the European Commission.³³ Currently, the Dutch government is again seeking to implement a CBIT-like regime called the group interest box regime. The European Commission decided that the newly designed interest box is not considered to be state aid and is therefore not placed on the list of harmful tax practices (Devereux, Elschner, Endres, Spengel,

³³ For this decision of the EC see: Ordination nr. 2003/568/EG of the European Commission (17 February 2003), concerning the implemented state aid regulation (art. 15b (old) VpB) in favor of international financing activities. (PbEG 2003, L 180/52).

Barthomeß, Dreßler, . . . Zinn, 2009; European Union, European Commission, 2009). The Dutch interest box regime contains some features of a CBIT system. It cannot be seen as a fully implemented CBIT regime since interest is still deductible at a rate of 5%. It is, however, one step closer to neutrality (De Mooij & Devereux, 2009, p. 16-18).

The reason why no real world examples exist of fully neutral CBIT systems is that unilateral implementation of a CBIT system would lead double taxation and double non-taxation in cross-border situations.

CBIT simulation studies

Few simulation studies are available which examine the effects of the implementation of a CBIT regime. Radulescu and Stimmelmayer examined the effect of a CBIT system in Germany in 2007. They found that the broader tax base increased government corporate tax revenues to the extent that the German VAT rate could be cut by 4,3% points. The model also predicts a rise in the cost of capital of 10% and a 10% reduction in investments. Finally, GDP was expected to drop by 5%, translating into a welfare loss of 0.7% of Germany's GDP (Radulescu & Stimmelmayer, 2007, p. 294-328).

4.2. ACE

The ACE system was proposed by the Capital Taxes Committee of the Institute for Fiscal Studies in 1991. The ACE system maintains the deductibility of actual interest returns and adds to this a notional return on equity that is deductible against corporate profits (Institute for Fiscal Studies, 1991). The tax deduction for corporate equity is certain for firms. Therefore, the notional return rate is set at the risk-free interest rate (e.g. government bonds) (Bond & Devereux, 1995, p. 57-71).

The ACE regime has several interesting properties. First, it ensures neutral treatment regarding debt and equity financing. Therefore, the need for a group interest box regime or thin-cap regulations is no longer present under an ACE system (De Mooij & Devereux, 2009, p. 10) It must be noted, however, that an ACE system will never be fully neutral unless the notional return rate adequately reflects the real return rate on equity for firms (De Mooij, 2011, p. 17). This real return rate on equity will differ between firms. Therefore, an ACE system will never be neutral for all firms. For policy reasons and efficiency, the risk-free interest rate is therefore merely 'the next best thing'.

Second, because the ACE allows for a deduction for all capital income, capital income is not taxed. The ACE thus reflects a tax on economic rents. This means that investments that earn exactly the cost of capital are not taxed. Investment behavior at the margin is therefore not affected. An ACE system thus successfully removes the bias towards debt finance if it is implemented in full extent.

Third, an ACE regime inherently means that the tax base becomes more narrow, which in turn leads to a reduction in government tax revenues. A way to compensate for the losses in revenue is to rise the statutory corporate tax rate. In a closed market, a higher statutory rate will not affect investment decisions, because the debt bias as such is no longer present. In an open market, however, economic rents have to be taken into account. These economic rents can be mobile. This may well result in a shift in the location of certain production factors (Bond, 2000). For example, firm specific rents associated with patents or brands might be relocated abroad in the event the statutory rate in the resident country rises.

Another unattractive result of a higher statutory tax rate is that it incentivizes firms to shift their profits abroad. It has to be noted that a loss in government tax revenue due to the narrower tax base does not have necessarily have to be balanced by a higher statutory corporate tax rate (De Mooij & Devereux, 2009, p. 11). Another option would be to rise the statutory tax rate on consumption. In this respect, different economic market results can be expected.

For an open economy, like the Dutch economy, the allowed reduction in the statutory rate under the CBIT system is very important. The openness of the Dutch economy is indicated by its large share of foreign direct investments in the world.³⁴ The ACE system may therefore not be suited for the Netherlands as its base narrowing induce higher tax rates, leading to profit shifting, relocation activities and fewer profitable investments. When implemented unilaterally, implementation of a CBIT system therefore yields higher welfare gains than an ACE system for countries with an open economy like the one in the Netherlands (De Mooij & Devereux, 2009, p. 92-93).

Forth, under a uniform implemented ACE regime, the international intercompany debt-equity structure becomes irrelevant for tax planning purposes. If, however, some countries decide not to implement the ACE system, it may be attractive for multinationals to locate their equity in

³⁴ According to the Centraal Bureau voor de Statistiek (CBS), the share of the Netherlands in the global stock of inward foreign direct investment was 2,5% in 2012. This amounts to an inward direct foreign investment stock of around 457 billion euro's in 2012.

the location where an ACE system is implemented. This way, they at least have some partially untaxed equity returns.

Fifth, unilateral implementation of an ACE system leads to erosion of the tax base of the source state in cross-border situations. The allowed deduction for notional equity and interest allocates the taxing rights of both the returns to the residence state, while the source state is entitled to tax the returns because it initially provided the goods and services for the production of the income. *Kemmeren* states that this issue can be resolved by implementing a withholding tax on interests in combination with the ACE system (Kemmeren, 2009).

Finally, the same problem regarding pre-existing capital (capital present before the implementation of an ACE system) exists for the ACE system as was the case for pre-existing debt under the CBIT system. If the ACE also includes existing capital, the allowance would simply be a windfall gain for investors, adding to the loss in government tax revenue. In order to reduce the loss in revenue due to implementation of an ACE system, allowing the allowance only for new equity might provide for a solution (De Mooij & Devereux, 2009, p. 12). In the long term, all capital will fall under the allowance. Therefore, this is merely a transitional issue.

Real world applications of ACE systems

Croatia, Italy, Belgium, Austria and Brazil all implemented or still make use of an ACE system. Due to the lack of empirical data, Brazil and Austria will not be assessed in this section.

Croatia implemented a textbook example of an ACE system between 1994 and 2000. It applied a notional rate of 5% (plus annual inflation) on firms' book value of equity. The Croatian ACE was abolished in 2001, because Croatia wanted to lower its statutory tax rate from 35% to 20%.

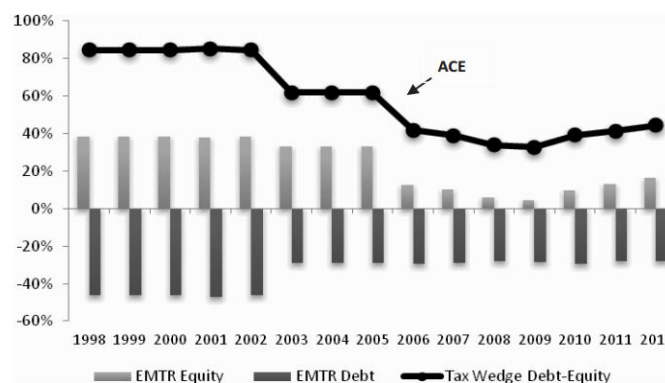
It is hard to assess the Croatian ACE. *Keen and King* attempted to make a rudimentary assessment by comparing Croatian developments with other Eastern European Countries. Their conclusion was that the ACE system had worked well for Croatia. GDP progress were similar to the control group of other Eastern European countries, while foreign investment was considered to be relatively high during the ACE period (Keen & King, 2003, p. 323-342).

Between 1997 and 2003, Italy introduced a Dual Income Tax system (DIT). The DIT is a restricted version of an ACE system. Under the DIT, a reduced rate was applied to notional interests for equity stocks. The reduced rate only applied to newly formed equity stock and not to existing equity stock in order to mitigate short-term budget losses of the Italian government.

At the time the central government introduced the DIT system, local governments in Italy also introduced a CBIT system. Due to the considerable amount of changes and the offsetting tax reforms of the local governments, it is hard to identify the economic implications of the introduction of the DIT system in Italy (De Mooij & Devereux, 2009, p. 13). Nonetheless, some studies have tried to assess these economic implications. They find that the DIT reduces the cost of capital in most cases during the implementation of the DIT in Italy. Also, the reform was found to diminish the discriminatory effects of taxes on financial structures (Bordignon, Gianni & Panteghini, 1999, p. 191-210). As a result, debt-asset ratios have declined during the period the DIT was implemented (Staderini, 2001). Finally, the probability of firms issuing equity instead of debt increased under the DIT (Oropallo & Parisi, 2005).

Belgium introduced a partial ACE system in 2006. The notional return rate is set on the monthly government bond rate and is capped at 6,5% and 0,5% for small and medium sized firms. Figure 1 illustrates the effect of the Belgian ACE system on the effective marginal tax rates (EMTR) on new debt and equity investments before and after the implementation of the ACE system.

Figure 1. EMTR in % on debt- and equity-financed new corporate investment, 1998-2012.



Note. Retrieved from Devereux et al. (2009). Effective tax levels using the Devereux-Griffith methodology.

ZEW. Retrieved from: http://ec.europa.eu/taxation_customs/resources/documents/common/publications/studies/etr_company_tax.pdf

The figure shows that from 2006 onwards, the EMTR for equity-financed investments has decreased due to the introduction of the notional interest deduction. By 2009, due to the introduction of the ACE system and an increase in the notional interest rate (effected in 2008), the debt bias has halved since 2005 (Zangari, 2014, p. 15). Nevertheless, Belgium still copes

with a debt bias in 2012 which is above the average rate in the EU27 (European Union, European Commission, 2013). One possible reason for this is that the notional interest rate of the Belgian ACE system is still below the normal market interest rate. This increases the gap between the EMTR of debt and equity (Zangari, 2014, p. 15). Another reason why Belgium implemented the new system, was that they wanted to attract more foreign investors. Belgium has definitely succeeded in this endeavor as foreign direct investment has grown significantly following the introduction of the ACE. Foreign companies increased their equity injections in Belgium firms which are acting as financing companies for their groups (Zangari, 2014, p. 16).

The introduction of the ACE also came with large budgetary costs. In 2006, the implementation of the ACE was estimated to lead to an acceptable budget cost of about EUR 0.5 billion. In 2009-2011, however, the annual budgetary cost was estimated to be around EUR 5.5 to 6.2 billion. It must be noted that the positive indirect effects of the ACE are estimated to lower the actual budgetary costs of the ACE system by 5-15% (Zangari, 2014, p. 17).

The empirical studies on ACE do not give clear-cut evidence on its economic implications. The reason for this is that there is mostly a lack of data or because the ACE was part of a larger reform package, making it hard to assess the impact of the ACE on its own (Zangari, 2014, p. 15). *Klemm*, however, states that there is an important lesson which can already be deducted from previous implementations of ACE systems. The lesson is that ACE-type reforms have not yet encountered real great difficulties in their implementation and they did also not lead to large outflows of domestic capital (Klemm, 2007, 229-262). International application of the ACE system remains a struggle. It is still not clear how the ACE system should be dealt with in Treaty negotiations and other international situations.

ACE simulation studies

Radulescu and Stimmelmayer performed a simulation study which describes two countries and is based on a firm which operates in either the corporate or the non-corporate sector. The model tries to describe investment behavior and financial behavior of these firms. The ACE system is financed by an increase in the value added tax rate. This increase in tax rate is needed to balance the tax revenue budget of the government. The study shows that the increase in the value added tax rate must be at least 5.1% points in order to maintain the budget balance. This is considered to be rather costly. Further, it shows that the cost of capital drops by 6.3% which results in an increase in investment by more than 20%. In the long run, GDP expands by 9% while, quite remarkably, welfare only rises by 0.08% (Radulescu & Stimmelmayer, 2007, 294-328).

4.3. Conclusion

The decision of levelling up or down is not simple. Both systems have their merits and demerits. The CBIT regime allows for a reduction in the statutory tax rate which attracts foreign mobile economic rents. On the other hand, it is not clear whether investments will actually increase because of the implementation of a CBIT system. Firms will also have to keep a comprehensive administration to know which debt is considered exempt CBIT debt or taxed non-CBIT debt. A simulation study by *Radulescu and Stimmelmayer* concerning the implementation of a CBIT regime predicts a rise of 10% in the cost of capital and a decrease of investment by 10%. No textbook example of a CBIT system has been implemented yet, only partial CBIT systems like thin-cap regulations and the Dutch group interest box regime. A real world evaluation on a CBIT regime is therefore not possible, yet needed. I reckon that this is also the reason why countries are reticent regarding testing such systems.

An ACE system is rather costly and could possibly be financed by a rise in the statutory tax rate. This higher rate might incentivize firms to shift their mobile profits and mobile production factors abroad. There are several real world examples of implemented ACE systems. It still remains extremely difficult to obtain clear cut evidence regarding the economic implications of an ACE system. This is mainly due to the lack of data or because the ACE system was part of a larger reform package, making it hard to assess the impact of the ACE on its own. A simulation study by *Radulescu and Stimmelmayer* shows that an ACE system will likely decrease the cost of capital and increase investment. *Klemm* states that an important lesson can be learned from the already implemented ACE systems. He states that ACE-type reforms have not yet encountered real great difficulties in their implementation and they did also not lead to large outflows of domestic capital.

5. Finding the best system

In the previous chapter, the properties of a CBIT and ACE system have been discussed. Several countries have already experimented with an ACE system. Some still implement the system and others already removed the system after a couple of years. To this day, no country has ever implemented a completely neutral CBIT system, only partial CBIT regimes. It is clear that both systems have their advantages and disadvantages. The question is whether there is a system available which diminishes or removes the disadvantages whilst still promoting neutrality. This chapter will evaluate which system would be the best alternative for the Dutch VPB 1969.

If both extreme ends of a neutral tax system do not provide a solution (ACE and CBIT), the answer must lie in between those two systems. This can lead to two different systems, which will be discussed in this chapter. First, an Allowance for Corporate Capital (Further: ACC) system will be discussed. Second, a combination of a CBIT and ACE system will be examined. Finally, a conclusion will be drawn.

5.1. Allowance for Corporate Capital

An alternative to levelling up or down is to remove the distinction between debt and equity all together. This can be achieved by allowing a general deduction on capital. This system is called an Allowance for Corporate Capital system. This kind of system was first introduced by *Aaron, Burman, & Steuerle* (2007, Chapter 4). He presented the system as a Business Enterprise Income Tax (Further: BEIT) and proposed the system as an alternative for the US corporate Income Tax.

The ACC is calculated by imputing a return on the company's total capital (OECD, 2007, p. 11). It will replace the current interest deductibility. An ACC system is fully neutral in the sense that the same deduction will be allowed for the return on capital irrespective of whether the investment is financed through debt or equity (Boadway & Bruce, 1984, p. 231-239). ACC systems are a very popular topic in ongoing tax reform discussions, because it realizes the same economic implications as the ACE system, but might also reduce complexity of the tax system because the actual difference between debt and equity for tax law purposes would cease to exist (OECD, 2007, p. 11). Tax administrations would no longer have to categorize financial instruments. The corporate capital deduction only depends on the book value of the firm's capital, irrespective of where this capital comes from.

Another big advantage of an ACC system is that it removes firm's incentives to apply non-arm's length interest rates. Governments are allowed to set the nominal imputed return rate at a rate they see fit. A good candidate may be the rate on medium term government bonds. Governments can also choose to allow a different return than the actual interest rate the firm has to pay. The part of the ACC that corresponds to the debt might therefore deviate from actual (non-deductible) interest payments made. Firms thus no longer face a tax induced incentive to use a non-arm's length interest rate (OECD, 2007, p. 11).

One major problem ACC systems face is that they may trigger double taxation issues in cross-border situations.³⁵ This situation occurs when the ACC system is implemented unilaterally by the Netherlands. In fact, this is the same effect that is achieved by implementing thin-cap regulations or earnings-stripping rules (Van Strien, 2007, p. 508-510). In the Netherlands, article 10d VPB 1969 entailed such a thin-cap regulation. Since 2013, it has been removed from Dutch tax law as it experienced great critique and caused double taxation issues in cross-border situations (Minister van Financiën, 2012). For this similar reason I do not consider the ACC system to be the optimal solution to the neutrality issue.

5.2. A combination between ACE and CBIT

The other option is a combination between an ACE system and a CBIT system. As stated before, both ACE and CBIT systems move the corporate income tax to a more neutral system regarding capital structures and investments. ACE systems reduce the cost of capital, but requires a higher statutory tax rate. A CBIT system achieves the exact opposite.

In principle, it is possible to combine ACE and CBIT reforms in order to mitigate distortions in company's capital structures without having implications for the cost of capital of corporate tax rates (Fatica et al., 2013, p. 5). This results in a tax system which allows for a partial deduction for notional returns as well as a partial deduction for interest expenses (van Strien, 2007, p. 562). The idea is to combine a partial ACE system with a partial CBIT system. For example, Italy and Austria experimented with a lower corporate tax rate on the nominal return of equity but allowed no full allowance. This can be described as a partial ACE system. Similarly, reforms including any thin-capitalization rules, income stripping regulations and even the Dutch interest box can be described as partial CBIT systems.

³⁵ This discussion relates double tax treaties as to where article 9 OECD Model Convention stands regarding unilateral thin-capitalization regulations.

A combined reform of a partial ACE and partial CBIT system mitigates the discrimination between equity and debt from both directions (De Mooij & Devereux, 2009, p. 19). Also, if the combined systems are applied in the right way, the offsetting effects of both systems on government tax revenue result in a revenue neutral reform. In theory, the combination between an ACE and CBIT system may currently be the best solution at hand.

Unfortunately, finding the best combination between the two systems is a very difficult task. The optimal combination should maximize any possible welfare gains. However, welfare maximization may not only require the minimization of financial distortions, but also other distortions of the corporate tax system. Examples of distortions may be investment distortions, location distortions and tax arbitrage distortions due to profit shifting activities. Moreover, the fact whether such combination system will be implemented unilaterally or multilaterally also affects the size of aforementioned distortions (De Mooij & Devereux, 2009, p. 19). The main issue is that these distortions differ for each country, resulting in different optimal combination systems for each country. This makes it difficult to implement a uniform (EU) combination system.

De Mooij and Devereux estimated the best combinations between ACE and CBIT for the EU27. They examined an EU uniform combination system reform which would be revenue-neutral and neutral towards financial decision making. This means that the total government tax revenue before the reform remains, on average, the same after the reform and that the percentages of CBIT and ACE must both add up to 100% (De Mooij & Devereux, 2009, p. 78). They find that the optimal combination requires 2/3 of an ACE system and 1/3 of a CBIT system. The revenue loss due to the 2/3 ACE part is, on average, offset by the extra revenue governments made due to the 1/3 CBIT part.

As explained before, every country may require a different combination of ACE and CBIT in order to end up with a revenue neutral and capital structure neutral tax system. *De Mooij & Devereux* (2009) find that in Italy, for example, a 73% ACE and 27% CBIT precisely adds up to a revenue neutral system while Cyprus requires a 54% ACE system. The fact that these ratios all differ from 1:1 suggests that the optimal system no longer safeguards total debt-equity neutrality. As indicated earlier, a new tax system must improve current neutrality issues, while still improving welfare. It is unrealistic to assume a new corporate tax system results in full neutrality from the instant it is implemented. The combination system is therefore not the perfect solution, but rather the next best thing.

The estimated effects of implementing a combination system are positive. On average, the debt share reduces by 6.1% (from 2.8% in Bulgaria up to 7% in Spain and France). The cost of capital is reduced by 0.1% on average, employment increases by 0.1%, GDP increases by 0.3% and welfare (in % of GDP) also increases with 0.3% (De Mooij & Devereux, 2009, p. 79). These effects can be considered small, yet positive. The reason the effects are small lies in the fact that the two reforms have opposing effects.

The increase in welfare can be associated with the benefit of removing the bias towards debt finance. The welfare gain confirms that the current social costs of debt finance exceed the private costs due to the discrimination of the tax system in favor of debt. The combination system removes this discrimination which incentivizes firms to lower their debt-ratios. Firms therefore save money on financial distress costs and agency costs, creating a social benefit (De Mooij & Devereux, 2009, p. 79). Similar results were found in the event of unilateral implementation of a combination system.

5.3. Conclusions

Both ACE and CBIT systems have their advantages and disadvantages, making them not the best solution for the capital neutrality issue at hand. In this chapter, the ACC system and an ACE/CBIT combination system were assessed in order to find the best possible solution.

The Allowance for Corporate Capital system introduced by *Aaron et al.* (2007, Chapter 4) looks very promising at first sight. The ACC is calculated by imputing a return on the company's total capital. An ACC system is fully neutral in the sense that the same deduction will be allowed for the return on capital irrespective of whether the investment is debt or equity financed. Tax administrations would no longer have to categorize financial instruments. The corporate capital deduction only depends on the book value of the firm's capital, irrespective of where this capital comes from. Another big advantage of an ACC system is that it removes firm's incentives to apply non-arm's length interest rates. Unfortunately, an ACC system has a great downside as well. ACC systems may trigger double taxation issues in cross-border situations, leading to the same issues as is the case with thin-cap and earnings-stripping regulations. The ACC system is therefore not the best solution to the neutrality issue.

The other option is a combination between an ACE system and a CBIT system. A combined reform of a partial ACE and partial CBIT system mitigates the discrimination between equity and debt from both directions (De Mooij & Devereux, 2009, p. 19). Also, the offsetting effects on government tax revenue result in a revenue neutral reform. In theory, the combination

between an ACE and CBIT system may currently be the best solution at hand. *De Mooij and Devereux* predict that welfare and GDP will increase by implementation of a combination system, even when the system is implemented unilaterally. For these reasons I find that the combination system is the best solution currently at hand for mitigating the neutrality issues of the Dutch corporate tax system.

6. Effects of introducing a combination system in the Netherlands

In the previous chapter, the conclusion was drawn that the best system at hand for mitigating the debt-equity distinction is a mixed CBIT/ACE tax system. In this chapter, it will be discussed which aspects of the Dutch economy and current tax law must be kept in mind when implementing the new system.

6.1. Implementing the new system

The aim of implementing the new combination system is to obtain a more neutral tax system and to obtain higher welfare as a result of increased efficiency. As discussed in the previous chapters, the CBIT and ACE system both have opposing effects on different aspects of a country's tax policy and businesses' decision making policies. They differ, for example, regarding their effects on investment, financial structures and international profit shifting and the size of the tax base. It is therefore crucial to determine to what extent both systems ought to be implemented in order to maximize utilization of such a combination system.

When the optimal ratio between ACE and CBIT has to be determined, both international as well as domestic aspects of the Netherlands must be kept in mind.

6.1.1. International Environment

The Netherlands is well known for its large multinational sector. Having a large multinational sector also implies attracting inward foreign investments. The ratios of inward and outward direct foreign investment (FDI) stocks to gross domestic product (GDP) is often used as a measure for the 'openness' of an economy (OECD, 2008, p. 20). The OECD describes FDI as a category of cross-border investment in which an investor resident in one economy establishes a lasting interest in and a significant influence over an enterprise resident in another country (10% voting power or ownership). According to the *Centraal Bureau voor de Statistiek* (CBS), the share of the Netherlands in the global stock of inward foreign direct investment was 2,5% in 2012. This amounts to an inward direct foreign investment stock of around 457 billion euro's in 2012 (CBS, 2013). Inward FDI are considered to be advantageous for the Netherlands for several reasons. For example, foreign direct investments can stimulate the economic development of the Netherlands, creating a more conducive environment. Foreign investments also create new jobs, allow for 'resource spillovers' like technological and expertise spillovers and increase national income which spurs economic growth.

The past few years, the share of inward foreign direct investment compared to GDP has declined. In 2009, this share was around 5% while in 2012 it was under 1% (CBS, 2013). It is therefore desirable that the new combination system stimulates the inward FDI of the Netherlands.

The Netherlands is highly placed in the OECD rankings when it comes to inward and outward FDI stocks. Inward FDI stocks amounted to 84% of GDP in 2013 in the Netherlands, while the OECD average is 32% of GDP, placing the Netherlands in the top 5. For outward FDI stocks, the Netherlands are in top 4 with outward FDI stocks amounting to 134% of GDP. The average of all the OECD countries' outward FDI stock to GDP was 43% in 2013 (OECD, 2016).

The risks of having a large multinational sector must also be kept in mind when choosing the right ratio for the new ACE/CBIT system. The size of the FDI stocks in the Netherlands have important implications regarding possible profit shifting activities. For example, a small change in the transfer price for a multinational located in the Netherlands will, on average, have a large impact on the Dutch corporate tax revenues. In contrast, a big change in the transfer price of a country with lower FDI stocks will have almost no impact on the tax revenues of that country (Betterhof, van der Horst & De Mooij, 2009, p. 25).

Transfer prices are negatively correlated to corporate tax rates. Higher corporate tax rates therefore lead to lower transfer pricing arrangements (Bernard, Jensen & Schott, 2006, p. 15-16). This in turn results in lower corporate tax bases. This effect can also directly be shown by looking at the elasticity of the corporate tax base related to corporate tax rates. The Netherlands have one of the largest elasticities of the EU in this regard due to the big multinational sector. A 1%-point higher corporate tax rate reduces the tax base via profit shifting by 0.8%.³⁶

A CBIT system allows for a reduction in the tax rate by broadening the tax base. An ACE system narrows the tax base, requiring the government to make more revenue through a higher corporate tax rate or higher tax rates on consumption or labor. These properties of the CBIT and ACE system therefore affect the ratio they should be used in regarding the combination system. As explained earlier, an ACE system shifts the tax burden from the normal return on capital towards economic rents. In an open economy, this might give businesses incentives to relocate their business since economic rents are mobile in some occasions (Cnossen, 2010, p. 53). This implies that multinationals with firm-specific economic rents are incentivized to

³⁶ This is the most recent estimate available and originates from 2008. See Betterhof et al. (2009, p. 29)

relocate to another country which has a lower tax burden on economic rents. This leads to an outflow of investments. The CBIT system shifts the tax burden away from economic rents. This in turn attracts mobile rents and may incentivize multinationals to relocate to the Netherlands. A combined system may therefore look ambiguous regarding the effect on investments. However, The Netherlands can be considered vulnerable regarding profit shifting and tax base erosion due to its large multinational sector. A combined system might therefore require the CBIT system to be more dominantly present compared to the EU-average in order to maintain the same levels of investment in the Netherlands.

6.1.2. Domestic implications

There are several domestic aspects that need to be kept in mind when implementing the new combination system. Should the system be implemented in full or gradually? What are the changes on the current corporate tax law? Does it matter whether the system is only implemented in the Netherlands or if it is implemented uniformly across Europe? Should the corporate tax rate be adjusted due to the new system? These questions all need to be answered before the new combination system can be applied. This section will try to provide insight into these issues. No conclusive implications can be derived from this section as there has not been performed sufficient research on most of these issues. Performing the research within this thesis would be out of its scope.

This thesis states no optimal ratio for the new combination system since not enough research is available for doing so. However, it is possible to indicate where the optimal ratio approximately lies. On average, *De Mooij and Devereux* (2009, p. 78) estimated the EU-average ratio ACE-CBIT to be 2:1 in a government tax revenue neutral setting. This suggests that the revenue loss due to the partial ACE is offset by the revenue gains from the partial CBIT. This holds even though the CBIT part makes up only 33% of the total system. The previous section, covering the international implications of the new system, suggests that the optimal ratio for the Netherlands requires a larger than average share of the CBIT system, increasing its share in the ratio. The ACE system will, however, still be dominant in the Netherlands.

The ratio ultimately determines the effect on the corporate tax base of the Netherlands. The more dominantly present ACE system results in a narrowing of the tax base in the Netherlands. This implies the need for a rise for the statutory tax rate of the corporate tax system or labor/consumption tax system in order to maintain the tax revenue needed for the government budget.

Further, the same problem regarding pre-existing capital (capital present before the implementation of the new system) exists for the combination system as was the case for pre-existing debt under the CBIT and ACE proposals. In the scenario the new system includes all capital, the allowance of the partial ACE will be a windfall gain for investors whom possess existing equity. These windfall gains add to the loss of government tax revenue. This suggests that the new system should be implemented gradually. One way to do this is to allow the allowance only for new equity. Similarly, restriction of the deduction of interest payments should be gradually increased over a sufficient period of time (Jacobs, 2010, p. 33). If the restriction would be implemented instantaneously, firms would be incentivized to create fiscal constructions in order to circumvent the restriction. Also, adjusting the tax system over a period of time gives firms time to adequately adjust their tax strategies. This way, bona fide firms will not suffer great losses due to the sudden implementation of a new tax system because they can prepare themselves for it by accounting for the new system in their tax strategy. In the long run, all capital will fall under the new system and interest deductions are restricted according to the optimal ratio. This discussion therefore entails merely a transitional issue.

It is also important to keep in mind that unilateral implementation of the combination system will lead to different outcomes than uniform implementation across the EU. It has to be noted that a uniform implementation of the same system is merely a theoretical possibility, not realizable in reality. The reason for this is that countries will most likely not give up their autonomy to regulate their own tax policy. Implementing the new system unilaterally automatically entails there will also be spillover effects towards other countries (De Mooij & Devereux, 2009, p. 56). The corporate tax base is likely to become narrower and the corporate tax rate will rise due to the larger share of the ACE in the new system. Firms will likely engage in profit shifting activities and might even relocate their business. If the system is implemented uniformly, governments could settle on one tax rate, mitigating the international spillover effect.

The CBIT part of the new system may work differently whenever the partial CBIT follows the description of a pure CBIT system as described in section 4.1. If this pure partial CBIT is introduced unilaterally, interest received from abroad will be considered to be non-CBIT interest and therefore taxed. In contrast, whenever the system is implemented uniformly across Europe, the interest from abroad will now come from another CBIT-entity and is therefore not taxed. In this scenario, unilateral implementation of the new system will render more tax revenues (De Mooij & Devereux, 2009, p. 73). Whenever the partial CBIT system entails thin-

capitalization or income stripping regulations, this issue will not be present since firms will not have to distinguish between CBIT entities and non-CBIT entities. Finally, unilateral implementation of a CBIT system triggers investment as it allows for a reduction in the corporate tax rate. Uniform implementation of the system entails settling on a reduced uniform tax rate, diminishing the individual advantages for the Netherlands.

6.1.3. Conclusion

To conclude, the international position of the Netherlands is very important for determining the optimal ratio between CBIT and ACE. The Dutch economy relies for a big part on its large multinational sector. Its economy is considered to be very open compared to other members of the EU. This brings many advantages for the Netherlands such as technological spillovers and economic development. However, having such a large multinational sector will also affect the ratio of ACE and CBIT of the new combination system. The vulnerability of having multinationals shifting their profits and even relocating their business suggest a bigger share of CBIT in the new combination system than the EU average 1/3rd part estimated by *De Mooij and Devereux* (2009).

The partial ACE system makes up a larger share in the ACE: CBIT ratio than the partial CBIT share in the proposed new system for the Netherlands. This results in a narrower tax base. In order to collect the same amount of corporate tax revenue, the corporate tax rate will have to rise. The new system should also be implemented gradually in order mitigate incentives towards aggressive tax planning. Further, the system should not provide allowances for already existing capital since this will create further losses for the government budget. Finally, the effects of uniform implementation may be ambiguous due to the opposite effects of both the partial ACE and CBIT system in the new combination system.

Conclusions and recommendations (English)

This thesis was set out to examine the differentiation between debt and equity and has examined the distinction from an economic as well as a civil and fiscal law point of view. Further, it identifies the impacts of treating debt and equity differently for fiscal purposes. The study also sought to find out which neutral tax reform systems are available and determined which reform would deliver the greatest advantages for the Netherlands in terms of tax system neutrality and welfare. The general theoretic literature on this subject, especially regarding the Netherlands, does not provide for a systematic review of the economic and fiscal implications of the debt-equity distinction and is inconclusive regarding the optimal corporate tax system reform for the Netherlands. The study sought to answer the following research question:

Is there a justification for the different treatment regarding debt and equity in the Dutch corporate tax system and what is the best corporate tax system reform option for the Netherlands in order to improve corporate tax system neutrality?

In order to find whether there is a justification for the debt and equity distinction in the Netherlands, possible legal grounds for the Dutch corporate tax system needed to be examined. The notion of independency principle cannot be the legal ground for the Dutch corporate tax system, because the notion of independency suggests deductibility of dividends. This is not the case under the current VPB 1969. The only way to see the notion of independence as the legal ground for corporate taxation, without allowing deduction for all dividends, would be to impute the LLC the ability to consume for its own good. In my view, this would require too much imagination and would assign human characteristics to the corporate body. From the global balance principle follows that profits should only be taxed once (ne bis in idem-principle). Rents that are not deductible for the debtor should not be taxed again at the creditor. Therefore, rents that are not deductible for the debtor should fall under the participation exemption. Since this is only the case for some hybrid debts at the moment, global balance is not present in the Dutch VPB 1969. Therefore, the global balance principle can, in my opinion, not be considered to be the legal ground for the Dutch VPB 1969. Both the notion of independency and the global balance principle do provide guidelines for the Dutch corporate tax system. However, it must be noted that neither can be solely seen as the legal ground for implementing corporate taxation. Without full implementation of either one of the principles, the Dutch corporate tax system can, in my opinion, not become a neutral tax system without reformation of the complete corporate tax system.

The fact that there is no clearly defined legal ground for the Dutch corporate tax system is also visible in the development of the Dutch corporate tax system since its implementation. Major developments in the tax system have never been reviewed and discussed properly due to the seemingly more important economic and governmental justifications for them. This is especially true regarding the debt-equity distinction under the corporate tax system, since the distinction has not been discussed by the Dutch parliament so far.

The analysis of the possible legal grounds of the Dutch corporate tax system and the review of the developments of the Dutch corporate tax system fails to provide justifications for the differential treatment of debt and equity in the Netherlands. Therefore, the thesis investigated the debt-equity distinction from three different perspectives: an economic perspective, a civil law perspective and a fiscal law perspective. By analyzing the risks involved with both forms of finance, the decisive characteristic clarifying the border between debt and equity financing can be distinguished. Debt investments do not embrace contingency while equity investments do. The question then is whether this distinction has any further implications from an economic point of view. Therefore, the functional equivalence theory and the comparable building blocks theory were assessed.

By expanding the capital structure theorem by *Modigliani and Miller*, the functional equivalence argument can be rejected. According to the Trade-off theory, firms only alter their capital structure if the marginal deadweight costs of bankruptcy are higher than the marginal benefit of the tax shield of debt. This theorem recognizes the difference between debt and equity regarding volatility risk. Further, the Pecking order theory states that firms will finance firstly with internal capital, then through debt investors and finally with equity. An examination of this theory proves that firms are indeed more inclined to issue debt claims than equity claims in the case of asymmetric information as a result of the risk assessment of both debt and equity. Finally, the Free cash flow theory provides indications that both fixed and contingent participation can be used as a tool to align manager performance with the goals of the firm. It further recognizes that both equity and debt can be used to align different managerial incentives. In my opinion, the functional equivalence argument is invalid because the evaluation of aforementioned theorem provides for sufficient examples illustrating that the functions of debt and equity actually do differ from a firm perspective. The comparable building blocks argument does not hold, because it relies on the use of external instruments in order to justify its argument. In my opinion, the fact that the argument needs these external instruments only confirms that there is indeed a difference in kind between debt and equity. Without the use of these external

instruments, debt and equity cannot simply be substituted for each other. The view that the debt and equity distinction is relevant from an economic point of view is supported by these findings.

There are sound reasons to differentiate between debt and equity from a civil law perspective. The main argument that can be made is that both debt and equity relate to different entitlements regarding the claims that can be made by the creditor and shareholder. The second justification for the differentiation between equity and debt relates to the fact that equity capital is considered to be permanent while debt capital has to be paid back to the creditor. Further, the distinction is important in the event a business liquidates. Shareholders are in a subordinated position regarding creditors to repayment of the invested capital. Finally, dividend payments are largely dependent on the profits of a business and are not obligatory while periodical interest payments are. If a firm decides to distribute its profits to its shareholder through dividend payments, the company has to comply with several legal restrictions. The view that the debt and equity distinction is relevant from a civil law point of view is supported by these findings.

In order to assess the distinction from a fiscal law point of view, the important question that needs to be answered is whether there is a difference between debt and equity that justifies the differentiation in treatment of their remuneration towards the capital investors. The source of capital does not influence the firm's decision how to invest the capital. Only the output an investment yields is relevant. The current corporate tax system characterizes debt at the production stage and equity at the distribution stage, implying that contingency makes a contribution less of a cost of production than a contribution in exchange for fixed payments. Interest payments and dividends represent the net earnings on invested capital. Disparate tax treatment therefore only results in an arbitrary differentiation between corporate income. It is irrelevant which contractual differences exist between debt and equity instruments. They are not decisive in the defining the definition of corporate income and therefore do not justify the differential treatment between them. It can be concluded that contingency cannot be seen as a distinctive factor for fiscal law purposes. In my opinion, the distinction between debt and equity for fiscal purposes should be eliminated. I do recognize that the distinction is not completely useless for fiscal law purposes. Tax policy addressing the distinction therefore requires a lot of attention.

Implementing a more neutral tax system comes with several advantages. A neutral tax system will counter the negative consequences concerning the current fiscal debt-bias such as highly leveraged firms, internal/external debt shifting and a more neutral system will mitigate the

negative consequences of the use of hybrid instruments. Simultaneously, higher levels of debt introduce great welfare losses and vulnerability for firms in the event of a crisis or recession. A neutral tax system stimulates firms to lower their leverage in order to safeguard themselves for times when the economy is not doing well. In the situation of an economic crisis, the market will recover much faster. Also, the welfare costs due to high debt levels will be significantly lower. Finally, a fully neutral corporate system will allow for a more understandable and cohesive tax system in comparison to the current litigation imbroglio.

The choice of levelling up or down translates in two radical reform systems: an ACE system and a CBIT system. Both reform options lead to opposing impacts on the Dutch fiscal and economic environment. The CBIT regime allows for a reduction in the statutory tax rate, which might attract foreign mobile economic rents. On the other hand, it remains ambiguous whether investments will actually increase. No textbook example of a CBIT system has been implemented yet, only partial CBIT systems like thin-cap regulations and the Dutch group interest box regime. A real world evaluation on a CBIT regime is therefore not possible, yet needed. I reckon that this is also the reason why countries are reticent regarding testing such systems. An ACE system is rather costly and could possibly be financed by a rise in the statutory tax rate. This higher rate might incentivize firms to shift their mobile profits and mobile production factors abroad. *Klemm* states that an important lesson can be learned from the already implemented ACE systems. He states that ACE-type reforms have not yet encountered real great difficulties in their implementation and they did also not lead to large outflows of domestic capital. In my opinion, unilateral implementation of either both systems cannot be the best alternative for the current corporate tax system due to spillover effects and their implications on the corporate tax base and rate. I suggest applying a tax system consisting out of a mix of both an ACE and a CBIT system. By applying the perfect ratio between the two systems, a tax system can be created which is revenue neutral compared to the current tax system, improves welfare in the Netherlands whilst still promoting neutrality. An ACC system does have several merits such as completely rendering the distinction between debt and equity irrelevant. However, double taxation issues related to the system make the combination system more attractive. I conclude that the combination system is the best solution currently at hand for mitigating the neutrality issues of the Dutch corporate tax system.

The optimal ratio between the ACE and CBIT system for the Netherlands depends on the characteristics of the Dutch economic and fiscal environment. The Netherlands is well known for its large multinational sector. The Netherlands have one of the largest profit shifting

elasticity of the EU in this regard. The combined system requires the CBIT system to be more dominantly present compared to the estimated EU-average in order to maintain the same levels of investment in the Netherlands. The ratio should consist of a greater part ACE than CBIT, whilst the CBIT part is larger than the EU-average estimate of $1/3^{\text{rd}}$ as estimated by *De Mooij and Devereux* (2009). In other words, $1/3 < \text{CBIT} < \text{ACE}$. The more dominantly present ACE system results in a narrowing of the tax base in the Netherlands. This implies the need for a rise for the statutory tax rate of the corporate tax system or labor/consumption tax system in order to maintain the tax revenue needed for the government budget. In order to prevent large losses to the government budget through windfall gains due to the allowance for already existing equity, the allowance should only apply to new equity. Similarly, restriction of the deduction of interest payments should be gradually increased over a sufficient period of time in order to mitigate negative spillover effects.

Recommendations for further research

This thesis suggests using a combination of a CBIT and an ACE system as the best reform solution system. This thesis provides general implications of such system as well as what needs to be kept in mind when implementing such system. It is crucial that the new system is well-tailored towards the Dutch economic, international and political environment. This means that further research needs to be performed regarding the optimal ratio of CBIT: ACE for the Netherlands. Further, the optimal system has been described as a combination of two systems. This means that neither of both systems can be fully implemented but only partially. There are more variations possible of both systems. Further research needs to clarify which variations of possible partial ACE and CBIT systems will suit the Netherlands the best.

Once the optimal ratio has been determined, the effects of the new system on the corporate tax base and tax rate will become clear. This thesis suggests using a larger share of the ACE system than the CBIT system in order to improve welfare, promote neutrality whilst being revenue neutral regarding the current corporate tax system. The new system will likely result in an increase in the corporate tax rate as a means to compensate for narrowing of the corporate tax base. Further research needs to examine the effect of this rise in the corporate tax rate. The main question should revolve around the actual impact of the higher statutory rate on government tax revenues. Tax policy theorem might provide valuable insight into this issue. The Laffer curve indicates the theoretical link between tax rates and tax revenues. The curve is represented as a graph, starting at a 0% tax rate resulting in 0 tax revenue and ends with a 100% tax rate resulting

again in 0 tax revenue. The shape of the curve depends on the characteristics of the tax system and environment of the country. Any rate below or above the optimal rate will decrease government tax revenues. Theorem states that there is an optimal tax rate which maximizes government tax revenues. A lower rate will result in lower revenues due to the fact that the marginal tax rate is still below the marginal benefit of earning another euro. A higher tax rate than the optimal tax rate will result in a loss of revenue because the marginal benefit of earning another euro is then lower than the marginal tax rate. In order to assess the impact of the higher tax rate on government tax revenues due to the combination system, further research needs to be performed regarding the position of the Dutch corporate tax system on the Laffer curve.

This thesis has explicitly mentioned that it will only discuss the corporate tax system implications of the debt-equity distinction. However, a fully neutral tax system also entails a neutral personal income tax system. Under the current personal income tax system in the Netherlands, implementation of the new system will have no implications for income falling under the so-called 'box 3', because this box currently does not differentiate between debt and equity. Box 3 does therefore not to be changed as a result of the new proposed combination system. However, it requires further research to determine the effects of the new combination system on Box 1 and Box 2, because these boxes do either only apply to dividend income or prescribe different treatment regarding debt and equity transactions.

Conclusions and recommendations (Dutch translation)

Deze thesis is geschreven om de huidig aanwezige differentiatie tussen eigen en vreemd vermogen te onderzoeken. Deze differentiatie is onderzocht vanuit een economisch, civielrechtelijk en fiscaal perspectief. Verder identificeert deze thesis de impacts die het fiscaal verschillend behandelen van vreemd en eigen vermogen met zich mee brengt. Daarnaast is er gekeken naar eventuele mogelijkheden betreffende neutrale belastingstelselhervormingen en is er geëvalueerd welke hervorming het beste is voor Nederland gelet op welvaartsimplicaties en systeemneutraliteit. De algemene literatuur over dit onderwerp, met name met betrekking tot Nederland, voorziet niet van een systematisch overzicht van de economische en fiscale implicaties van het onderscheid dat gemaakt wordt tussen eigen en vreemd vermogen. Daarnaast geeft de literatuur geen eenduidig overtuigend antwoord op het vraagstuk welk type hervorming van de huidige vennootschapsbelasting het meest optimaal is voor Nederland. Deze studie tracht de volgende onderzoeksvraag te beantwoorden:

Is er een rechtvaardiging aanwezig voor het verschillend behandelen van eigen en vreemd vermogen onder de Nederlandse vennootschapsbelasting en welk type belastingstelselhervorming is het beste alternatief voor de huidige vennootschapsbelasting betreffende systeemneutraliteit en welvaartsimplicaties?

Om rechtsvaardigheidsgronden te vinden voor de differentiatie tussen eigen en vreemd vermogen in Nederland zijn mogelijke rechtsgronden van de Nederlandse vennootschapsbelasting onderzocht. De zelfstandigheidsgedachte kan geen geldige rechtsgrond zijn voor de Nederlandse vennootschapsbelasting aangezien deze impliceert dat dividenden aftrekbaar behoren te zijn. Onder het huidige systeem is dit echter niet mogelijk. De enige manier om de zelfstandigheidsgedachte toch te zien als de formele rechtsgrond van de vennootschapsbelasting, zonder aftrekbaarheid van dividenden toe te staan, is om de NV de kwaliteit te geven om voor zichzelf te kunnen consumeren. In mijn mening zou dit een te groot voorstellingsvermogen vereisen aangezien dit betekent dat er menselijke eigenschappen aan de NV toegeëigend moeten worden. Het principe van globaal evenwicht omarmt het ‘ne bis in idem-principe’. Rente die niet aftrekbaar is voor de debiteur, hoort daarnaast niet ook nog belast te worden bij de crediteur. Niet aftrekbare rente zou dus onder de deelnemingsvrijstelling horen te vallen volgens dit principe. Onder het huidige recht is dit echter niet het geval, met uitzondering van enkele hybride leningen. Mede hierdoor kan er geconcludeerd worden dat er op het moment geen globaal evenwicht aanwezig is onder de Nederlandse VPB 1969. Hieruit

trek ik de conclusie dat het principe van globaal evenwicht ook geen geldige rechtsgrond voor de huidige VPB 1969 kan zijn. Zowel de zelfstandigheidsgedachte en het principe van globaal evenwicht voorzien ons wel van nuttige richtlijnen voor de vennootschapsbelasting ook al kunnen ze beide niet zelfstandig als rechtsgrond aangemerkt kunnen worden. Zonder volledige implementatie van een van de twee principes zal een neutrale vennootschapsbelasting in mijn ogen dan ook niet mogelijk zijn zonder dat het hele systeem hervormd moet worden.

Het feit dat er geen duidelijke rechtsgrond voor de huidige vennootschapsbelasting aanwezig is, valt ook te af te leiden uit een terugblik op de ontwikkelingen van de vennootschapsbelasting sinds haar implementatie. Veel grote en belangrijke ontwikkelingen van het belastingsysteem zijn nooit goed geëvalueerd en besproken. Als reden hiervoor wordt vaak het argument gebruikt dat de economische en beleidsimplicaties van de wetgeving hier simpelweg voorrang verkrijgt en evaluatie en verantwoording van de ontwikkelingen dus naar de achtergrond worden verschoven. Als voorbeeld hiervan kan ook de discussie betreffende de differentiatie tussen vreemd en eigen vermogen genoemd worden. Deze discussie heeft namelijk tot op heden nooit plaats gevonden binnen het Nederlandse Parlement.

Het onderzoek naar mogelijke rechtsgronden van de VPB 1969 en een terugblik op de ontwikkelingen ervan voorzien niet van rechtvaardigingen voor differentiatie tussen eigen en vreemd vermogen onder de huidige vennootschapsbelasting. Daarom onderzoekt deze thesis de differentiatie tussen eigen en vreemd vermogen verder vanuit drie verschillende perspectieven: een economisch perspectief, een civielrechtelijk perspectief en een fiscaal-juridisch perspectief. Door de risico's te analyseren die gemoeid zijn met beide soorten van financiering kan de beslissende karakteristiek welke de grens tussen beide vormen van financiering aangeeft geïdentificeerd worden. Als bepalende factor kan worden aangewezen dat vreemd vermogen eventualiteit verwerpt terwijl eigen vermogen eventualiteit juist omarmt. De vraag die vervolgens is of de factor van eventualiteit ook verdere consequenties heeft vanuit een economisch perspectief. Om deze vraag vervolgens te beantwoorden zijn vervolgens de 'functional equivalence theory' (verder: FE) en de 'comparable building blocks theory' (verder: CBB) uitvoerig geëvalueerd.

Indien de kapitaalstructuur theorie van *Modigliani & Miller* verder uitgebreid wordt, kan de FE-theorie verworpen worden. De uitbreiding van de kapitaalstructuur theorie wordt vormgegeven door gebruik te maken van de 'Trade-off theory', de 'Pecking order theory' en de 'Free Cash Flow theory'. De Trade-off theory stelt dat bedrijven hun kapitaal structuur alleen

zullen wijzigen wanneer de marginale deadweight kosten gerelateerd aan faillissement hoger zijn dan de marginale opbrengsten van het ‘tax shield’ welke geproduceerd wordt door gebruik te maken van vreemd vermogen. Deze theorie erkent het verschil tussen eigen en vreemd vermogen met betrekking tot het risico van volatiliteit. De Pecking order theorie stelt dat bedrijven zich eerst zullen wenden tot intern kapitaal ter financiering van hun bedrijf. Vervolgens zal de rangorde aangevuld worden door financiering met behulp van vreemd vermogen en als laatste zullen bedrijven gebruik maken van financiering via het eigen vermogen. Na deze theorie onderzocht te hebben, moet geconcludeerd worden dat bedrijven inderdaad geneigd zijn eerder met vreemd vermogen dan met eigen vermogen hun bedrijven te financieren in de situatie waarbij er sprake is van asymmetrische informatie. De oorzaak hiervan ligt bij de analyse van bedrijven betreffende de verschillende risico’s die gepaard gaan met financiering van vreemd en eigen vermogen. Ten slotte stelt de Free Cash Flow theorie dat zowel participaties met een vaste beloning als participaties met een eventualiteit gebonden voorwaardelijke beloning gebruikt kunnen worden om de prikkels die de prestaties van managers beïnvloeden, op een lijn te plaatsen met de doelen van het bedrijf. Daarnaast erkent deze theorie dat zowel vreemd vermogen als eigen vermogen gebruikt kan worden om managers op verschillende wijzen te prikkelen. Mijn conclusie is dat de FE-theorie verworpen dient te worden aangezien de voorgenoemde theorieën voldoende situaties schetsen waarbij de functies van vreemd en eigen vermogen verschillen vanuit het perspectief van het bedrijf. Het CBB-argument dient naar mijn mening ook verworpen te worden. Het argument behoeft externe instrumenten te gebruiken om zichzelf te kunnen rechtvaardigen. Juist het feit dat externe instrumenten nodig zijn toont in mijn mening dat er dus wel degelijk een verschil is tussen beide vormen van financiering. Zonder het gebruik van deze externe instrumenten zouden vreemd en eigen vermogen niet zomaar met elkaar verwisseld kunnen worden. De gevonden resultaten steunen dus het standpunt dat differentiatie tussen eigen en vreemd vermogen vanuit een economisch standpunt wel degelijk relevant is.

Vanuit een civielrechtelijk perspectief moet ook geconcludeerd worden dat de differentiatie tussen vreemd en eigen vermogen relevant is. Als hoofdargument kan aangevoerd worden dat zowel eigen als vreemd vermogen leiden tot verschillende aanspraken welke gemaakt kunnen worden door de aandeelhouders respectievelijk de crediteurs. Een tweede rechtvaardiging van het argument omslaat het feit dat eigen vermogen meer permanent van aard is terwijl vreemd vermogen in ieder geval een terugbetalingsverplichting bevat. Ook is de differentiatie relevant in geval van liquidatie. Aandeelhouders staan in een ondergeschikte positie ten opzichte van

crediteuren met betrekking tot terugbetaling van het geïnvesteerde kapitaal. Ten slotte zijn uitkeringen van dividend veelal gebonden aan de behaalde winsten van het bedrijf. Uitkeringen van deze winst is niet verplicht. Wanneer het bedrijf besluit dividenden uit te keren, zal het bedrijf daarbij moeten voldoen aan enkele juridische verplichtingen. Deze argumenten leiden tot de conclusie dat differentiatie tussen eigen en vreemd vermogen wel degelijk relevant is vanuit een civielrechtelijk perspectief.

Om te kunnen beoordelen of de differentiatie tussen vreemd en eigen vermogen ook relevant is vanuit een fiscaal-juridisch perspectief, zal de vraag beantwoord moeten worden of er een verschil tussen eigen en vreemd vermogen aanwezig is welke de verschillende behandeling van de vergoeding voor het verstrekken van het kapitaal aan de kapitaalverstrekkers rechtvaardigt. Ten eerste dient vermeld te worden dat de bron van het kapitaal geen invloed heeft op de beslissingen van bedrijven over hoe het kapitaal verder te investeren. Alleen de opbrengst welke de investering genereerd is hierbij relevant. De huidige vennootschapsbelasting karakteriseert vreemd vermogen in de productiestage van het bedrijf terwijl eigen vermogen gekarakteriseerd wordt in de distributiefase van het bedrijf. Dit impliceert dat de wetgever de karaktereigenschap van eventualiteit, gerelateerd aan de vergoeding voor een kapitaalcontributie, dus minder snel aanmerkt als kosten gerelateerd aan productie dan wanneer er sprake is van vaste vergoedingen voor kapitaalcontributies. Betalingen van rente en dividend representeren de netto-opbrengsten van geïnvesteerd kapitaal. Een verschillende fiscale behandeling voor beide vergoedingen resulteert dus in een willekeurige differentiatie van bedrijfsinkomen. Het is niet relevant welke contractuele verschillen er bestaan tussen instrumenten van eigen en vreemd vermogen. Deze zijn namelijk niet beslissend bij het definiëren van bedrijfsinkomen en kunnen dus ook geen rechtvaardigheidsgrond zijn voor differentiële behandeling tussen eigen en vreemd vermogen. Hieruit kan geconcludeerd worden dat eventualiteit niet als een onderscheidende factor gezien moet worden voor fiscale doeleinden. Naar mijn mening zal de differentiatie tussen eigen en vreemd vermogen voor fiscale doeleinden afgeschaft moeten worden. Erkent moet worden dat de differentiatie tussen beide financieringsvormen voor fiscale doeleinden niet geheel zinloos is. Het is daarom zeer belangrijk dat bij belastingbeleid deze differentiatie voldoende aandacht gegeven gaat worden in de toekomst.

Het implementeren van een neutraler belastingsysteem zal enkele voordelen met zich meebrengen. Een neutraal systeem kan het hoofd bieden aan de huidige problemen die gepaard gaan met de fiscale bevoordeling van financiering via vreemd vermogen. Deze problemen betreffen het overmatig gebruik van vreemd vermogen door bedrijven, interne en externe

verschuiving van vreemd vermogen en de negatieve consequenties van het gebruik van hybride instrumenten. Overmatig gebruik van vreemd vermogen resulteert in welvaartsverliezen en verhoogt de kwetsbaarheid van bedrijven in tijden van crisis of recessie. Een neutraal belastingsysteem stimuleert bedrijven minder vreemd vermogen op zich te nemen om op deze manier zich beter te kunnen weren in tijden van crisis. Een bijkomend effect hiervan is dat de economie ook sneller kan herstellen na tijden van crisis. Tevens zullen de welvaartskosten die het resultaat zijn van de hoge niveaus van vreemd vermogen dalen en zal systeemneutraliteit bijdragen aan een makkelijker te begrijpen en een meer samenhangend belastingsysteem. Dit laatste dient is uiterst welkom gezien de huidige litigation imbroglio welke veel wetgevers en fiscalisten de nodige hoofdpijnen opgeleverd heeft de laatste jaren.

De keuze tussen een ‘level up’ of ‘level down’ van het huidige systeem vertaalt zich in twee radicale hervormingssystemen: het ACE-systeem en het CBIT-systeem. Beide hervormingsopties leiden tot tegengestelde effecten op het Nederlandse fiscale en economische milieu. Het CBIT-regime staat toe dat het belastingtarief naar beneden bijgesteld kan worden. Dit heeft een positief effect op de aantrekking van buitenlandse mobiele economische renten. Anderzijds blijft het onduidelijk of het aantal investeringen daadwerkelijk zal stijgen. Tot op heden zijn er geen voorbeelden aanwezig van een volledig toegepast CBIT-regime. Er zijn wel voorbeelden van een gedeeltelijk ingevoerd CBIT-regime. Voorbeelden hiervan zijn thin-cap wetgeving en de Nederlandse groepsrentebox. Vanwege het gebrek aan een volledig toegepast CBIT-regime is het daarom niet mogelijk een volledige evaluatie te geven van een CBIT-regime. Gezien het potentieel dat een dergelijk systeem te bieden heeft, is verder onderzoek naar de werkelijke toepassing ervan zeer wenselijk. Ik acht het gebrek aan deze evaluaties dan ook een van de argumenten voor landen om niet te experimenteren met een CBIT-systeem.

Een ACE-systeem is zeer prijzig om te introduceren. Financiering van een ACE-systeem zal daardoor moeten plaatsvinden door een stijging van het belastingtarief. Dit hogere tarief kan bedrijven aansporen om hun mobiele winsten en productiefactoren te verplaatsen naar het buitenland. *Klemm* stelt dat er wel al belangrijke lessen geleerd kunnen worden van de al geïmplementeerde ACE-systemen. Hij argumenteert dat ACE-hervormingen tot op heden tot geen grote problemen hebben gezorgd betreffende de implementatie ervan en dat deze implementaties ook niet geleid hebben tot uitvloeijing van binnenlands kapitaal.

Naar mijn mening zal unilaterale implementatie van een van beide hervormingsopties niet leiden tot het gewenste resultaat gezien het feit dat beide systemen te maken hebben met

negatieve uitvloeingseffecten en gezien hun implicaties voor de belastinggrondslag en het belastingtarief. Ik stel daarom voor om een mix van beide systemen in te voeren. Wanneer de optimale ratio tussen het gebruik van beide systemen bepaald kan worden, kan er een systeem gevormd worden welke opbrengst neutraal is in vergelijking met het huidige systeem. Tevens zal dit leiden tot een toename in de welvaart terwijl er nog steeds een verschuiving plaatsvindt richting een neutraal systeem. Het grote voordeel van een ACE-systeem zit hem in het feit dat implementatie van een dergelijk systeem het onderscheid tussen eigen en vreemd vermogen vrijwel overbodig maakt. Door de problemen inzake dubbele belastingheffing die inherent zijn aan het systeem, acht ik het voorgesteld combinatiesysteem toch meer aantrekkelijk. Ik concludeer dan ook dat het combinatiesysteem op het moment de beste oplossing is voor het verhelpen van de problemen die veroorzaakt worden door het huidige niet neutrale Nederlandse belastingsysteem.

Bij de bepaling van de optimale ratio tussen de ACE en CBIT-systemen dienen de karakteristieken van de Nederlandse economie en haar fiscale milieu in acht genomen te worden. Nederland staat bekend om haar grote multinationale sector. Nederland heeft tevens een van de grootste winstverschuivingselasticiteiten van de EU. Het voorgestelde combinatiesysteem vereist daardoor een groter aandeel van het CBIT-regime in de totale breuk van beide systemen ten opzichte van het geschatte EU-gemiddelde om hetzelfde investeringsniveau in Nederland te handhaven. Het ACE-regime dient in de totale breuk dominant te zijn over het CBIT-regime, terwijl het deel van CBIT-regime dus groter dient te zijn dan het EU-gemiddelde ($1/3^{\circ}$ deel CBIT zoals geschat door *De Mooij & Devereux* (2009)). In andere woorden, $1/3 < \text{CBIT} < \text{ACE}$. De dominantie van het ACE-systeem zal leiden tot een versmalling van de belastinggrondslag van de Nederlandse vennootschapsbelasting. Dit impliceert dat er een stijging van het belastingtarief vereist is om het belastingbudget te handhaven. Deze stijging kan zowel in de Wet VPB plaatsvinden als in de Wet op de loonbelasting of in het systeem van de omzetbelasting. Om te voorkomen dat het belastingbudget uitgehold kan worden, dient de hervorming in beginsel alleen van toepassing te zijn op nieuw aangewend eigen vermogen. Tegelijkertijd zullen de restricties op de aftrekbaarheid van renten geleidelijk moeten worden ingevoerd om zo negatieve uitvloeingseffecten het hoofd te bieden.

Aanbevelingen voor verder onderzoek

Deze thesis stelt voor om een systeem in te voeren welke bestaat uit een combinatie van een CBIT-systeem en een ACE-systeem. Algemene implicaties en aandachtspunten betreffende de invoeren van een dergelijk systeem zijn hierbij behandeld. Het is belangrijk dat er bij de invoering van het hervormingssysteem nauwkeurig gelet wordt op het Nederlandse economische, politieke en internationale milieu. Dit is nodig om zo een voor Nederland op maat gemaakt systeem te kunnen invoeren. Dit betekent dat er verder onderzocht gedaan dient te worden naar de voor Nederland optimale ratio van het CBIT-systeem en ACE-systeem. Verder is het optimale systeem beschreven als een combinatie van de twee systemen. Dit betekent dat geen van beide systemen volledig geïmplementeerd wordt, maar beiden enkel gedeeltelijk geïmplementeerd kunnen worden. Er zijn hierbij meerdere varianten en combinaties van de systemen mogelijk. Verder onderzocht dient te verduidelijken welke variaties van beide partiële systemen het beste bij Nederland zal passen.

Wanneer de optimale ratio bepaald is, zullen ook de consequenties van het nieuwe systeem voor de grondslag en belastingtarief duidelijk worden. In deze thesis wordt gesteld dat het ACE-systeem dominant aanwezig dient te zijn om welvaart te laten toenemen, neutraliteit te promoten en budgetneutraal te blijven ten opzichte van het huidige systeem. Het nieuwe systeem zal naar alle waarschijnlijkheid als gevolg hebben dat het belastingtarief verhoogd dient te worden. Op deze manier kan de ingekrompen belastinggrondslag gecompenseerd worden teneinde het belastingbudget onaangetast te laten blijven. Verder onderzoek dient te analyseren wat de verdere effecten zullen zijn van deze tariefsverhoging. Belangrijk hierbij is dat er gekeken wordt naar de effecten van het hogere tarief op de belastinginkomsten voor de regering. Theorieën omtrent optimaal belastingbeleid kunnen hierbij van waarde zijn. Zo voorziet de Laffer curve ons van een theoretische link tussen belastingtarieven en belastinginkomsten voor de overheid. De curve wordt vormgegeven door een diagram. Deze begint bij een belastingtarief van 0% welke resulteert in 0 euro belastinginkomsten en eindigt bij een belastingtarief van 100%, welke ook weer resulteert in 0 euro belastinginkomsten. De uiteindelijke vorm van de curve wordt bepaald door de specifieke karaktereigenschappen van het belastingstelsel het land zelf. Elk tarief onder of boven het optimale tarief zal resulteren in een afname van belastinginkomsten voor de overheid. Een lager tarief zal tot lagere opbrengsten leiden doordat het marginale belastingtarief lager is dan de marginale opbrengsten die gepaard gaan met het verdienen van een extra euro. Elk tarief boven het optimale tarief zal ook resulteren in verlaging van de opbrengsten aangezien de marginale opbrengst per

additioneel verdiende euro lager is dan het marginale belastingtarief. Verder onderzoek dient verduidelijking te geven omtrent wat het optimale belastingtarief zou zijn voor Nederland. Daarnaast dient er onderzocht te worden waar Nederland op dit moment zit op de laffer curve ten opzichte van dit optimale tarief.

Deze thesis vermeld expliciet dat alleen de implicaties van de differentiatie tussen eigen en vreemd vermogen op de vennootschapsbelasting onderzocht zullen worden. Het behoeft echter geen betoog om te stellen dat een volledig neutraal systeem ook inhoudt dat het inkomsten belastingstelsel op persoonlijk niveau neutraal is. Invoering van het voorgestelde systeem zal geen consequenties hebben voor het inkomen dat momenteel in box-3 belast wordt aangezien er bij de belastingheffing van dit inkomen geen onderscheid gemaakt wordt tussen eigen en vreemd vermogen. Het Box-3 systeem behoeft dan ook geen verandering te ondergaan bij invoering van het nieuwe systeem. Verder onderzoek dient er echter wel gedaan te worden naar de implicaties van het nieuwe systeem op het Box-1 en Box-2 inkomen, omdat deze boxen ofwel alleen van toepassing zijn op dividenden, ofwel verschillende behandeling tussen eigen en vreemd vermogen vereisen.

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