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Sovereignty, Integration, and Tax Avoidance in the European Union: Striking the Proper Balance

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**SOVEREIGNTY, INTEGRATION AND TAX AVOIDANCE IN THE
EUROPEAN UNION: STRIKING THE PROPER BALANCE**

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Articles

Sovereignty, Integration and Tax Avoidance in the European Union: Striking the Proper Balance

LILIAN V. FAULHABER*

As the need to raise revenue becomes more pressing and public opposition to tax avoidance increases, the European Court of Justice has made it more difficult for the twenty-seven Member States of the European Union to prevent tax avoidance and shape fiscal policy. This article introduces the new anti-avoidance doctrine of the European Court of Justice and analyzes it from the perspective of taxpayers, Member States and the European Union legal order as a whole. This doctrine is problematic because it has created a legislative vacuum in Europe. No European Union institution has the authority to regulate direct taxation without the unanimous support of all twenty-seven Member States. As the European Court of Justice strikes down Member State efforts to prevent tax avoidance, no institution can step in to replace these Member State provisions. Member States are thus losing sovereignty over policing tax avoidance, but no legislative move toward an integrated approach is possible without the support of Member States. This article proposes several solutions to the problems posed by the doctrine.

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I. INTRODUCTION

In recent months, efforts by taxpayers to avoid or evade taxation have filled the news. From the agreement by world leaders at the G20 summit in April 2009 to publicize a list of tax havens¹ to growing awareness of investors failing to report offshore bank accounts,² efforts both to avoid taxation and to prevent such avoidance have captured the public attention. This is perhaps not surprising given the economic climate. As budgets shrink, raising revenue by way of taxation becomes increasingly important, and public outrage

1. See *Tax Haven Blacklists to Be Issued Soon*, REUTERS UK, April 2, 2009, available at <http://uk.reuters.com/article/topNews/idUKTRE5313LS20090402> (last visited August 11, 2009).

2. See Editorial, *Oh, That Account*, N.Y. TIMES, Oct. 18, 2009, available at <http://www.nytimes.com/2009/10/19/opinion/19mon2.html> (last visited November 28, 2009).

at attempts to avoid taxation increases. In Europe, however, the twenty-seven member state countries (Member States) of the European Union (EU) are losing the ability to respond fully to tax avoidance. Over the past ten years, the European Court of Justice (ECJ or Court) has created a doctrine limiting the ability of Member States to police tax avoidance, effectively making Europe more open to tax avoidance just as raising revenue becomes even more necessary for Member State survival.

This Article introduces the ECJ's recently created anti-avoidance doctrine, analyzes its far-reaching consequences and proposes a variety of responses. The effect of the doctrine can best be understood by considering President Obama's recent proposal to curb international tax avoidance. In its press release announcing international tax reforms, the White House stated with disapproval that "[n]early one-third of all foreign profits reported by U.S. corporations in 2003 came from just three small, low-tax countries: Bermuda, the Netherlands, and Ireland."³ The rules that the White House proposes strengthening are just the types of rules—referred to in this Article as anti-avoidance rules—that the European Court of Justice is striking down. Because of the ECJ's anti-avoidance doctrine, Member States cannot pass rules that would prevent tax avoidance in the Netherlands and Ireland—both Member States themselves—unless they apply *only* to "wholly artificial arrangements." What are wholly artificial arrangements? Taxpayers and Member States remain without definite guidance, but the ECJ has made clear that far fewer transactions can be prohibited in the EU than Member States would like.

Part II of this Article introduces readers to the ECJ's new anti-avoidance doctrine, which this Article labels the "wholly artificial arrangements doctrine." This doctrine is effectively a principle of limitation, pursuant to which Member State anti-avoidance rules are limited to preventing only wholly artificial arrangements. The wholly artificial arrangements doctrine grew out of the ECJ's freedom of movement jurisprudence, and the Court has developed this doctrine in the context of cases challenging the legitimacy of Member State anti-avoidance rules (anti-avoidance cases). While many commentators have previously addressed the ECJ's fairly recent incursion into the area of direct taxation⁴ and some have referred specifically to

3. Press Release, The White House, *Leveling the Playing Field: Curbing Tax Havens and Removing Tax Incentives for Shifting Jobs Overseas* (May 4, 2009).

4. See, e.g., Reuven S. Avi-Yonah, *What Can the US Supreme Court and the European Court of Justice Learn from Each Other's Tax Jurisprudence?*, in 14 *COMPARATIVE FISCAL FEDERALISM: COMPARING THE EUROPEAN COURT OF JUSTICE AND THE*

Member State efforts to justify measures with reference to prevention of tax avoidance,⁵ this Article is the first of its kind to introduce and chart the development of the wholly artificial arrangements doctrine from a U.S. perspective.

Part III situates the doctrine in the context of other anti-avoidance doctrines, as well as the ECJ's abuse of law jurisprudence, and analyzes the doctrine along three dimensions. First, from the point of view of taxpayers in the EU, the wholly artificial arrangements doctrine suffers from unpredictability and ambiguity while also creating an environment of greater tax avoidance. For Member States, the wholly artificial arrangements doctrine is problematic because it requires them to amend or overturn domestic anti-avoidance rules, thereby limiting their ability to raise revenue and shape fiscal policy. Finally, the wholly artificial arrangements doctrine is problematic for the EU legal order as a whole because it creates a legislative vacuum in which the ECJ strikes down anti-avoidance rules, but no other EU institution has the authority to police tax avoidance on an EU-wide basis without the unanimous support of all twenty-seven Member States. Member State sovereignty is threatened, tax avoidance is more likely and no solution to this impasse currently exists.

Some may argue that the wholly artificial arrangements doctrine and the associated loss of Member State tax authority over policing tax avoidance are the logical next step in the Court's free movement jurisprudence. Many commentators have written about the major changes to corporate law that the ECJ's recent decisions

US SUPREME COURT'S TAX JURISPRUDENCE 465, 465 (Reuven S. Avi-Yonah et al. eds., 2007) ("In the last twenty years, but with increasing frequency in the last five, the European Court of Justice (ECJ) has interpreted the Treaty of Rome aggressively to strike down numerous Member State income tax rules on the ground that they were discriminatory."); Ruth Mason, *US Tax Treaty Policy and the European Court of Justice*, in 14 *COMPARATIVE FISCAL FEDERALISM: COMPARING THE EUROPEAN COURT OF JUSTICE AND THE US SUPREME COURT'S TAX JURISPRUDENCE* 405, 407 (Reuven S. Avi-Yonah et al. eds., 2007) ("Although the ECJ rendered no decisions on income taxation for its first thirty years, it has made up for that initial quiescence with a vengeance. Over the last twenty years, the ECJ invalidated a wide variety of important and longstanding domestic tax laws on the theory that they resulted in nationality discrimination by preferring resident taxpayers."); Michael J. Graetz & Alvin C. Warren, Jr., *Income Tax Discrimination and the Political and Economic Integration of Europe*, 115 *YALE L.J.* 1186 (2006); *Taxing Judgments*, *THE ECONOMIST*, Aug. 28, 2004, at 67 (quoted in Tracy A. Kaye, *Tax Discrimination: A Comparative Analysis of US and EU Approaches*, in 14 *COMPARATIVE FISCAL FEDERALISM: COMPARING THE EUROPEAN COURT OF JUSTICE AND THE US SUPREME COURT'S TAX JURISPRUDENCE* 191, 195 (Reuven S. Avi-Yonah et al. eds., 2007)) ("While European Union governments do their best to avoid harmonizing taxation, the EU's court of justice is busy doing it for them").

5. RUTH MASON, *PRIMER ON DIRECT TAXATION IN THE EUROPEAN UNION* 101-05 (2005).

have wrought,⁶ while others have argued that Member States effectively agreed to the unforeseen effects of integration when they joined the EU.⁷ Direct taxation, however, differs from other areas that have been affected by the Court's drive for integration because it falls under Article 94 of the EC Treaty, a treaty provision that is understood to require the unanimous consent of the Member States for EU legislation in this area.⁸ The vacuum created by the wholly artificial arrangements doctrine is notable because it results from the EU's asymmetric approach to direct taxation. In the area of direct taxation, ECJ jurisdiction is coupled with a lack of authority on the part of any other EU institution to pass related legislation without the unanimous agreement of the twenty-seven Member States. This asymmetry explains why the legislative vacuum does not exist in other controversial areas of law, such as immigration or foreign poli-

6. See, e.g., Benjamin Angelette, Note, *The Revolution that Never Came and the Revolution Coming—De Lasteyrie du Salliant*, Marks & Spencer, *Sevic Systems and the Changing Corporate Law in Europe*, 92 VA. L. REV. 1189, 1219 (2006); Ronald Gilson, *Globalizing Corporate Governance*, 49 AM. J. COMP. L. 329 (2001) (discussing the effect of *Centros* on Europe's "equilibrium of diverse corporate regimes"); Carsten Gerner-Beuerle & Michael Schillig, *The Mysteries of Freedom of Establishment After Cartesio*, <http://ssrn.com/abstract=1340964> (arguing that *Cartesio* "introduces new subtleties and complexities which will render freedom of establishment for companies a rather ineffective tool for the establishment of the Internal Market").

7. See, e.g., Servaas van Thiel, *The Future of the Principle of Non-Discrimination in the EU: Towards a Right to Most Favored Nation Treatment and a Prohibition of Double Burdens?*, in 14 COMPARATIVE FISCAL FEDERALISM: COMPARING THE EUROPEAN UNION COURT OF JUSTICE AND THE US SUPREME COURT'S TAX JURISPRUDENCE 331, 399 (Reuven S. Avi-Yonah et al. eds., 2007) [hereinafter van Thiel 2007]; Servaas van Thiel, *The Direct Income Tax Case Law of the European Court of Justice: Past Trends and Future Developments*, 62 TAX L. REV. 143, 186 (2008) [hereinafter van Thiel 2008].

8. Article 94 provides: "The Council shall, acting unanimously on a proposal from the Commission and after consulting the European Parliament and the Economic and Social Committee, issue directives for the approximation of such laws, regulations or administrative provisions of the Member States as directly affect the establishment or functioning of the common market." Treaty Establishing the European Community, Dec. 29, 2006, 2006 O.J. (C 321E) 37. Although Article 94 does not specifically refer to direct taxation, lawmakers, judges and academics have interpreted it to cover this area. See Tracy A. Kaye, *Tax Discrimination: A Comparative Analysis of U.S. and EU Approaches*, 7 FLA. TAX REV. 47, 64 (2005) (stating that "[i]t is understood, however, that Article 94 of the Treaty, in the chapter on 'Approximation of Laws,' also provides a legal basis for direct taxation harmonization measures. This Article authorizes the Council, acting unanimously on a proposal from the Commission, to issue directives for the approximation of laws that 'directly affect the establishment or functioning of the common market.'"). All references to the "EC Treaty" refer to the Consolidated Version of the Treaty Establishing the European Community, Dec. 29, 2006, 2006 O.J. (C 321E) 37 [hereinafter EC Treaty].

cy.⁹ Furthermore, legislative vacuums such as that created by the wholly artificial arrangements doctrine are becoming less common as the EU as a whole moves away from a unanimity requirement toward greater use of qualified majority voting.¹⁰ The Court's encroachment on direct taxation is thus remarkable in that the Court has granted itself the ability to strike down Member State measures in an area in which activity by EU institutions is forbidden without the approval of all Member States—and in an area that is integral to the ability of Member States to raise revenue. This is an unsustainable situation.

Part IV proposes three groups of responses to this situation. Since the problems with the wholly artificial arrangements doctrine ultimately stem from the impossibility of protecting both Member State sovereignty over direct taxation and the freedom of movement necessary for greater integration, the only possible long-term solution is for the EU as a whole to prioritize either sovereignty or integration.¹¹ Due to the current political climate, however, such a decision

9. Although authors have criticized the ECJ's incursion into immigration law by way of the free movement principle, *see generally* Francis J. Conte, *Sink or Swim Together: Citizenship, Sovereignty, and Free Movement in the European Union and the United States*, 61 U. MIAMI L. REV. 331 (2007), the ECJ's recent decisions in this area have not led to a legislative vacuum. Instead, since Member States and EU institutions have themselves been involved in the development of a theory of EU citizenship, *see id.* at 345–47, the asymmetry at work in direct taxation does not exist. ECJ jurisdiction co-exists with action by other EU institutions. In the area of foreign policy, although EU institutions have limited legislative authority, asymmetry is also not a problem because the ECJ lacks jurisdiction. *See, e.g.*, Malgorzata Lawrynowicz, Note, *A Foreign Policy for Europe: Integration or Illusion?*, 16 MICH. ST. J. INT'L L. 691, 714 (2008). Thus, while other areas raise problems of *either* aggressive ECJ encroachment or inactivity on the part of EU institutions, direct taxation is striking for the vacuum created by the interaction of these two characteristics and the resulting vacuum. Even when the institutions of the EU have received the unanimous support necessary to overcome this vacuum, this has only occurred in narrow areas. *See infra* note 32.

10. For more on the current requirements of qualified majority voting, *see* Art. 205(2). *See also* Media Briefing from the Royal Economic Society, *Decision-Making in the EU's Council of Ministers: Why 'Qualified Majority Voting' Matters* (Jan. 2008); Stephen M. Johnson, *Economics v. Equity II: The European Experience*, 58 WASH. & LEE L. REV. 417, 431 n.78 (2001) (stating that most environmental matters now require only qualified majority voting); Gregory Shaffer, *Globalization and Social Protection: The Impact of EU and International Rules in the Ratcheting Up of U.S. Privacy Standards*, 25 YALE J. INT'L L. 1, 42 n.172 (2000) (stating that most data privacy protection also requires only qualified majority voting).

11. This Article argues only that the Member States and institutions of the EU must make a decision between sovereignty and integration, and it does not argue that one or the other is the correct decision. Although it could be argued that the unanimity requirement of Article 94 creates the same problems that existed in the Articles of Confederation, *see generally* CALVIN H. JOHNSON, *RIGHTEOUS ANGER AT THE WICKED STATES: THE MEANING*

is unlikely.¹² Along with discussing the ultimate long-term solutions to the problems presented by the wholly artificial arrangements doctrine, Part IV proposes several shorter-term reforms and advocates replacing the wholly artificial arrangements doctrine with a three-part flexible standard. Part V concludes.

II. THE WHOLLY ARTIFICIAL ARRANGEMENTS DOCTRINE

Tax avoidance is any effort to avoid paying taxes that would otherwise normally be payable. Unlike tax evasion, which is any fraudulent or illegal effort to avoid paying taxes, tax avoidance encompasses all efforts to avoid taxation, including tax planning and other efforts not specifically barred by law.¹³ The existence of multiple taxing jurisdictions adds a layer of complexity to the world of tax avoidance. Because different jurisdictions define and tax income differently and there is no worldwide authority for overseeing taxation, nor is there a consistent information-sharing arrangement between jurisdictions,¹⁴ taxpayers have many opportunities to shift in-

OF THE FOUNDERS' CONSTITUTION (2005), thus suggesting that integration is the logical next step, it could also be argued that the different histories of the Member States make it less likely that integration will be prioritized over sovereignty.

12. Although some commentators believe that greater integration is the foreseeable next step since Member States implicitly agreed to greater integration by joining the EU, *see van Thiel 2008, supra* note 7, the recent rejection of Member States to proposals to harmonize taxation, *see infra* note 167, suggests that further integration is not inevitable.

13. Note that this Article does not attempt to further define tax avoidance, nor does it advocate policing a certain level of tax avoidance. There is no universal definition of tax avoidance, nor is it clear that transactions that one country considers tax avoidance would be considered tax avoidance by another country. *See Shannon Weeks McCormack, Tax Shelters and Statutory Interpretation: A Much Needed Purposive Approach*, 2009 U. ILL. L. REV. 697, 703 (2009) ("Surprisingly, there is no widely accepted definition of a tax shelter, meaning there is no agreed upon definition of the type of transaction we are trying to stop."). This Article instead accepts countries' definitions of tax avoidance for what they are—evidence of determinations by sovereign nations as to what is or is not acceptable within their borders. For more on the negative effects of tax avoidance, *see infra* notes 102–05 and accompanying text.

14. Although jurisdictions are embarking on specific information sharing agreements, there is not yet an agreement that covers anywhere close to all the jurisdictions and income associated with international tax avoidance. A prime example of the limited collaboration currently taking place is the Joint International Tax Shelter Information Centre (JITSIC), which was established in 2004 by the tax commissioners of Australia, Canada, the United Kingdom and the United States. Internal Revenue Service, *Australia, Canada, U.K. and U.S. Agree to Establish Joint Task Force*, IR-2004-61 (May 3, 2004), available at <http://www.irs.gov/newsroom/article/0,,id=123016,00.html>. Japan agreed to join JITSIC in 2007. Internal Revenue Service, *Joint International Tax Shelter Information Centre*

come and assets between jurisdictions so as to reduce or avoid direct taxation. International tax avoidance takes many forms, but two of the primary categories of multi-jurisdictional tax avoidance are deferral and allocation.¹⁵

Tax avoidance by way of deferral occurs when a taxpayer shifts income to a foreign jurisdiction where the income is not subject to taxation—or is subject to lower taxation—and then defers taxation until repatriation.¹⁶ Deferral schemes often involve taxpayers creating or investing in a foreign corporation that is partially or wholly owned by a domestic corporation. Taxpayers may, of course, engage in cross-jurisdictional investment for numerous reasons unrelated to tax avoidance. Certain types of transactions, however, are considered by many jurisdictions to constitute impermissible deferral schemes.¹⁷ Common anti-deferral regimes designed by jurisdictions to defeat such schemes include controlled foreign corporation (CFC) rules,¹⁸ foreign personal holding company (FPHC) rules,¹⁹ and passive foreign investment company (PFIC), or foreign investment fund (FIF), rules.²⁰ Under all of these anti-deferral regimes, domestic shareholders of certain foreign companies are taxed as if they had received current pro rata distributions of the foreign companies' undistributed in-

Expands and Opens a Second Office in the United Kingdom, IR-2007-104 (May 23, 2007), available at <http://www.irs.gov/newsroom/article/0,,id=170735,00.html> (last visited Jan. 29, 2010). Another example of such collaboration is the Seoul Declaration, issued by 39 countries and organizations under the auspices of the Organisation for Economic Co-operation and Development (OECD) in 2006. See Organisation for Economic Co-operation and Development, Sept. 14–15, 2006, *Final Seoul Declaration*, available at <http://www.oecd.org/dataoecd/0/14/37463807.pdf> (last visited Jan. 29, 2010).

15. Both of these categories can be seen as examples of variations on shifting income from high-tax to low-tax jurisdictions. See Julie Roin, *Can the Income Tax Be Saved? The Promise and Pitfalls of Adopting Worldwide Formulary Apportionment*, 61 TAX L. REV. 169, 180 (2008). Note that this Article uses “allocation” instead of “apportionment” to prevent the confusion of tax apportionment with formulary apportionment.

16. See Robert J. Peroni, J. Clifton Fleming, Jr. & Stephen E. Shay, *Getting Serious About Curtailing Deferral of U.S. Tax on Foreign Source Income*, 52 SMU L. REV. 455, 457 (1999) (referring to the deferral privilege as “one of the fundamental features of the U.S. system for taxing international income”).

17. Although there is no objective guideline as to what counts as harmful deferral. See generally Organisation for Economic Co-operation and Development [OECD], *Harmful Tax Competition: An Emerging Global Issue*, at 25–36 (1998) (guidance from the OECD on harmful deferral).

18. Peroni, Fleming & Shay, *supra* note 16, at 457; see also I.R.C. §§ 951–965 (2006).

19. Peroni, Fleming & Shay, *supra* note 16, at 462; see also I.R.C. §§ 551–558, repealed by Pub. L. 108–357, Title IV, Sec. 413(a)(1) (Oct. 22, 2004).

20. Peroni, Fleming & Shay, *supra* note 16, at 463, 495; see also I.R.C. §§ 1291–1298 (2006).

come during the taxable year.²¹ As international deferral schemes have become both more common and more creative, such anti-deferral regimes have become increasingly popular. CFC rules, for example, originated with the original passage of Subpart F in the United States in 1962, and they now number well over a dozen in OECD countries, with the OECD encouraging all member states to adopt and enforce such rules.²²

Tax avoidance by way of allocation of income occurs when a taxpayer shifts income or assets to a related taxpayer in another, lower-tax, jurisdiction, thereby shifting the taxation of the income or assets to the lower-tax jurisdiction. The best-known example of tax allocation to avoid or reduce taxation is transfer pricing, pursuant to which a corporation transfers certain income-producing assets to another jurisdiction.²³ A further example of avoidance through allocation is thin capitalization, pursuant to which a company develops a high debt-to-equity ratio due to borrowing beyond its borrowing capacity and is thus able to take excessive interest deductions. Thin capitalization, or earnings stripping, rules prohibit such deductions,

21. For example, Company A, a resident of Country A, is a majority shareholder in Company B, a resident of Country B. Under an extremely simplified anti-deferral regime, certain shareholders of Company A resident in Country A would be taxed on their pro rata share of the income earned by Company B in the relevant taxable year. Anti-deferral regimes, such as Subpart F or the defunct FPHC rules of the United States Internal Revenue Code (Code), are of course much more complex, but the previous example illustrates the general concept of anti-deferral regimes.

22. See Peroni, Fleming & Shay, *supra* note 16, at 492–93; Organisation for Economic Co-operation and Development, *Harmful Tax Competition: An Emerging Global Issue* 40–42 (1998) (recommending the adoption of CFC rules).

23. For an illustration of transfer pricing, imagine that Company A and Company B are related companies and that Country B is a lower-tax jurisdiction compared to Country A. Company A sells its income-producing assets to Company B, thus shifting the taxes owed on those assets to the lower-tax jurisdiction. Under a simplified set of transfer pricing rules to police such activities, Country A would require that the sale of the assets from Company A to Company B be done on an arm's length basis such that Company B pays the amount for those assets that an unrelated party would pay in a comparable transaction. For more on arm's length pricing, see, for example, Arthur J. Cockfield, *Balancing National Interests in the Taxation of Electronic Commerce Business Profits*, 74 TUL. L. REV. 133, 148–49 (1999) (stating that model tax treaties, OECD guidelines and U.S. transfer pricing rules generally require that tax authorities look at taxpayers in comparable circumstances and comparable transactions to determine arm's length pricing).

Note that none of the cases discussed herein address transfer pricing, since the Commission established the EU Joint Transfer Pricing Forum in 2001 and later adopted a Code of Conduct in 2004. While neither of these regimes prevents the ECJ from considering a transfer pricing case, they appear to have made such cases less likely. For more on the Joint Transfer Pricing Forum, see generally Ben J.M. Terra & Peter J. Wattel, *European Tax Law* 572–73 (5th ed. 2008).

either above a certain limit or in the case of borrowing between related parties.²⁴

Since the EU consists of twenty-seven different taxing jurisdictions, Member State residents are faced with numerous opportunities for tax avoidance. Whether allocating income to different lower-tax Member States or deferring taxation until income is repatriated from another Member State, residents of the EU that hope to avoid taxation have many options available to them. Member States, particularly those with higher levels of taxation than their neighbors, have responded by passing numerous anti-avoidance rules and developing or strengthening anti-avoidance standards.²⁵ These efforts, however, are being threatened by recent European Court of Justice decisions.

Although Member State residents have many opportunities for tax avoidance, they did not, until recently, necessarily have more such opportunities than residents of other countries. United States taxpayers, for example, had the ability to create tax avoidance schemes both by deferring taxation by shifting income out of the country and by allocating income and assets both to other countries and to other states. Whether the tax avoidance in question was being pursued by a United States or, say, a German taxpayer, the taxpayer's jurisdiction had the ability to prevent such avoidance by passing an anti-avoidance rule. Due to recent decisions by the European Court

24. See I.R.C. § 163(j). Thin capitalization rules prohibit interest deductions for interest paid by foreign parent companies if the local subsidiary has a high debt-to-equity ratio. "The general purpose of . . . thin capitalization provisions, which are common in developed countries, is to prevent tax avoidance. Without such provisions, local subsidiaries of foreign parents could disguise nondeductible dividends as deductible interest, thereby shifting a portion of the corporate tax base from the source country to a lower-tax foreign country." Graetz & Warren, *supra* note 4, at 1202.

Under simplified thin capitalization rules, deductions taken by Company A for interest payments to Company B would be disallowed, either partially or wholly, and those payments from Company A to Company B would be re-characterized as dividends. Avoidance by way of allocation is a concern both between the states of a federation and between foreign countries. See Roin, *supra* note 15, at 204 (referring to the dangers of factors in the United States' formulary apportionment scheme becoming "open to taxpayer manipulation"); I.R.S. News Release IR-2006-142 (Sept. 11, 2006) (announcing a \$3.4 billion settlement in the transfer pricing dispute with GlaxoSmithKline).

25. One example is Germany's codification of abuse of law in 2008, in which Germany prohibits "inappropriate legal arrangement." Philip R. West, *Antiabuse Rules and Policy: Coherence or Tower of Babel?*, 49 TAX NOTES INT'L 1161, 1171 (2008) (stating that the German codification "would appear to be similar to the disjunctive version of the economic substance test as applied in the United States").

of Justice, however, Member States are no longer as free as other jurisdictions to pass anti-avoidance rules.²⁶

Because of its essential ties to national sovereignty, direct taxation remains one of the areas over which Member States have resisted ceding authority to the EU and its institutions. Although indirect taxation requires unanimity for harmonization,²⁷ Member States were willing to devote multiple articles of the EC Treaty to this area,²⁸ and Member States have been more willing to harmonize indirect taxation from the very start of the integration process.²⁹ Various factors may explain the greater willingness of Member States to cede sovereignty over indirect taxation, including the necessity of harmonized indirect taxation for a common market³⁰ and the role that indirect tax revenue plays in funding the EU.³¹ Furthermore, even though Member States have been more willing to accept the harmonization of indirect taxation, this harmonization has thus far not been so complete as to include uniform rates.³² In contrast to indirect taxation, direct taxation falls under only one article of the EC Treaty. Under Article 94, direct taxation is also subject to unanimity voting in the Council, but its strong link to Member State sovereignty means that very few EU measures regulating direct taxation have been proposed.³³

26. See *infra* notes 58–76 and accompanying text.

27. EC Treaty, *supra* note 8, art. 93.

28. See EC Treaty, *supra* note 8, arts. 90–93; see also Kaye, *supra* note 8, at 64 (“Although the Treaty specifically covers indirect taxes, Article 293 contains the only explicit reference to direct taxes and provides that Member States shall enter into negotiations to eliminate double taxation.”).

29. See, e.g., Rossi Q. Marco, *An Italian Perspective on Recent ECJ Direct Tax Decisions*, 50 TAX NOTES INT’L 775, 775–76 (2008) (stating that the European Coal and Steel Community (ECSC), the precursor to the EU, established an ECSC levy in 1951).

30. See European Commission, Taxation and Customs Union, *How VAT Works*, http://ec.europa.eu/taxation_customs/taxation/vat/how_vat_works/index_en.htm (last visited September 14, 2009) (explaining the need to shift from cascade taxes to harmonized indirect taxes as part of the common market).

31. See Council Directive 2006/112, 2006 O.J. (L 347) I, ¶ 8 (EC).

32. See *id.* ¶ 29 (establishing a floor on VAT); *id.* art. 284(2) (establishing a ceiling on exemptions).

33. Professor Kaye has noted that “[t]he scope of European direct tax legislation is limited to a few corporate tax directives, a savings directive, and mutual assistance directives.” Tracy A. Kaye, *Europe’s Balancing Act: Trends in Taxation*, 62 TAX L. REV. 193, 194 (2008). Amongst these regulatory measures is the Parent-Subsidiary Directive, which “exempts from withholding tax intercorporate dividends and profit shares paid by a qualifying EU subsidiary to its qualifying EU parent corporation that owns at least 10% of its stock.” Walter Hellerstein, Georg W. Kofler & Ruth Mason, *Constitutional Restraints on Corporate Tax Integration*, 62 TAX L. REV. 1, 14 (2008). See Council Directive 90/435,

Despite Member State efforts to retain control over direct taxation, one EU institution is not limited by Article 94 in its treatment of taxation. Although direct taxation is under the purview of Member States, this control extends only so far as the limits of Community law. In a phrase oft-repeated by the European Court of Justice, “[a]lthough direct taxation is a matter for the Member States, they must nevertheless exercise their direct taxation powers consistently with Community law.”³⁴ The ECJ thus has the authority to determine whether Member States are exercising their powers of direct taxation consistent with Community law, and the court has recently focused much greater attention on this area. As commentators have noted, direct taxation is now “one of the most important crossroads of European integration,”³⁵ with a growing number of cases addressing taxation in general and direct taxation in particular.³⁶

1990 O.J. (L 225) 6 (BEC) (“on the common system of taxation applicable in the case of parent companies and subsidiaries of different member states”), as amended by Council Directive 2003/123, 2004 O.J. (L 7) 41 (EC) [hereinafter Parent-Subsidiary Directive]. For more on the direct tax legislation that currently exists, see generally INTRODUCTION TO EUROPEAN TAX LAW ON DIRECT TAXATION (Michael Lang et al. eds., 2008).

Note that the unanimity requirement for direct taxes is more nuanced in certain respects, with enhanced cooperation now a possibility for certain tax legislation. Under enhanced cooperation, which is provided for in Article 280d/TFU 329 of the Treaty of Lisbon, nine or more Member States may move forward in certain legislative areas without the agreement of other Member States, although unanimity amongst those participating states is still required. However, the ability of any EU institution to pass direct tax legislation is also limited by the principle of subsidiarity, which applies to all areas of EU law and only allows Community action if the objectives of such action cannot be achieved by individual Member State action. See Kaye, *supra*, at 193.

34. See, e.g., Case C-264/96, Imperial Chem. Indus. PLC (ICI) v. Kenneth Hall Colmer (HM Inspector of Taxes), 1998 E.C.R. I-4695 ¶ 19. See also, e.g., Case C-347/04, Rewe Zentralfinanz eG v. Finanzamt Köln-Mitte, 2007 E.C.R. I-02647, ¶ 21; Case C-334/02, Commission v. French Republic, 2004 E.C.R. I-2229, ¶ 21; Case C-386/04, Centro di Musicologia Walter Stauffer v. Finanzamt München für Körperschaften, 2006 E.C.R. I-08203, ¶ 15; Joined Cases C-397/98 and C-410/98, Metallgesellschaft Ltd. v. Commissioners of Inland Revenue, 2001 E.C.R. I-1727, ¶ 37; Case C-374/04, Test Claimants in Class IV of the ACT Group Litigation v. Commissioners of Inland Revenue, 2006 E.C.R. I-11673, ¶ 36; Case C-446/04, Test Claimants in the FII Group Litigation v. Commissioners of Inland Revenue, 2006 E.C.R. I-11753, ¶ 35.

35. Pasquale Pistone, *The Need for Tax Clarity and the Application of the Acte Clair Doctrine to Direct Taxes*, 35 INTERTAX 534, 534 (2007).

36. One out of eight completed cases in 2006 addressed taxation in general, and one-third of those cases focused on direct taxation. *Id.* See also Suzanne Kingston, *A Light in the Darkness: Recent Developments in the ECJ's Direct Tax Jurisprudence*, 44 COMMON MKT. L. REV. 1321, n.4 (2007) (noting that there were only twenty-six judgments on the compatibility of national direct tax rules with the fundamental freedoms during the period from the ECJ's founding through March 2001, but that there were forty-nine such judgments

Due to the lack of European legislation currently addressing direct taxation, most direct tax cases before the ECJ raise questions about direct taxation within the context of freedom of movement, which protects free movement of workers,³⁷ freedom of establishment,³⁸ freedom to provide services³⁹ and free movement of capital.⁴⁰ These freedoms are directly applicable, and are therefore automatically guaranteed to citizens of all Member States, without need for domestic implementing legislation.⁴¹ Neither domestic legislation nor international agreements may supersede the freedom of movement under EU law,⁴² and there is no *de minimis* exception for a restriction on one of the freedoms.⁴³ As the ECJ established in *Daily Mail*, a citizen of one Member State cannot be restricted in the exercise of these freedoms by either its home state or a host state.⁴⁴ In other words, the ECJ's jurisprudence prohibits any Member State legislation from distinguishing between that Member State's residents and similarly situated residents of another Member State.⁴⁵

from April 2001 through April 2007); *Kaye*, *supra* note 4, at 195 (stating that, until mid-2005, there had been about 100 direct tax cases, with all but seven of these cases striking down the Member State tax provision in question).

37. EC Treaty, *supra* note 8, art. 39.

38. *Id.* art. 43.

39. *Id.* art. 49.

40. *Id.* art. 56. In many cases, the freedoms overlap, and the ECJ is asked to consider whether a measure constitutes a restriction on more than one freedom. See Case C-386/04, *Centro di Musicologia Walter Stauffer v. Finanzamt München für Körperschaften*, 2006 E.C.R. I-8203, ¶ 24 (noting that all of the freedoms are overlapping). The ECJ's current approach to such situations is the "centre of gravity" approach, under which the court considers only the freedom that is primarily affected by the legislation in question, even if the legislation leads to secondary restrictions on other freedoms. *Kingston*, *supra* note 36, at 1324.

Note that while the first three Articles apply only to restrictions on Member States, Article 56 also prohibits restrictions that affect non-Member State countries. See EC Treaty, *supra* note 8, art. 56 (prohibiting "restrictions on the movement of capital between Member States and between Member States and third countries").

41. Joined Cases C-397/98 & C-410/98, *Metallgesellschaft Ltd. v. Comm'rs of Inland Revenue*, 2001 E.C.R. I-1727, ¶ 41.

42. See, e.g., Case C-196/04, *Cadbury Schweppes plc v. Comm'rs of Inland Revenue*, 2006 E.C.R. I-7995, ¶ 4.

43. Case C-9/02, *Hughes de Lasteyrie du Saillant v. Ministère de l'Économie, des Finances et de l'Industrie*, 2004 E.C.R. I-2409, ¶ 43 (stating that "a restriction on freedom of establishment is prohibited by Article 52 of the Treaty even if of limited scope or minor importance").

44. Case C-81/87, *The Queen v. HM Treasury*, 1988 E.C.R. 5483. Many direct cases involve the resident of a Member State invoking the freedoms against his or her home state. *Kingston*, *supra* note 36, at 1327.

45. For more on the ECJ's freedom of movement analysis, see Ruth Mason, *Made in*

In analyzing freedom of movement cases, including those addressing direct taxation, the court generally applies a three-part test. First, does the national law restrict the applicable freedom of movement or otherwise discriminate? If yes, is there an overriding requirement of general interest that justifies such restriction or discrimination? If yes, does the national legislation ensure achievement of the aim in question and not go beyond what is necessary for that purpose?⁴⁶

In considering the first prong in the context of direct taxation, the court does not consider issues of tax symmetry but rather focuses entirely on whether similarly situated taxpayers are treated differently due to residence—either their own residence or that of related taxpayers. In cases addressing thin capitalization rules, for example, the ECJ considers the fact that one subsidiary may deduct interest payments while another may not to be a sufficient barrier to freedom of movement to satisfy this first requirement. That the first subsidiary's parent is a resident taxpayer and the second subsidiary's parent is a non-resident taxpayer does not lead the ECJ to treat the subsidiaries as differently situated.⁴⁷ In other words, the ECJ interprets this prong broadly, finding discrimination or restriction based on differential treatment of taxpayers construed liberally to be similarly situated.

It is during consideration of the second prong that Member States raise prevention of tax avoidance as a justification for a restrictive or discriminatory measure. Justifications fall into two categories:

America for European Tax: The Internal Consistency Test, 49 B.C. L. REV. 1277 (2008); Ruth Mason, *Flunking the ECJ's Tax Discrimination Test*, 46 COLUM. J. TRANSNAT'L L. 72 (2007).

46. See, e.g., Case C-105/07, *NV Lammers & Van Cleeff v. Belgische Staat*, 2008 E.C.R. I-00173, ¶ 25; Case C-231/05, *Oy AA*, 2007 E.C.R. I-06373, ¶ 44; Case C-347/04, *Rewe Zentralfinanz eG v. Finanzamt Köln-Mitte*, 2007 E.C.R. I-02647, ¶ 37; Case C-524/04, *Test Claimants in the Thin Cap Group Litig. v. Comm'rs of Inland Revenue*, 2007 E.C.R. I-02107, ¶ 64; Case C-196/04, *Cadbury Schweppes plc v. Comm'rs of Inland Revenue*, 2006 E.C.R. I-07995, ¶ 47; Case C-446/03, *Marks & Spencer plc v. David Halsey (HM Inspector of Taxes)*, 2005 E.C.R. I-10837, ¶ 35; Case C-9/02, *Hughes de Lasteyrie du Saillant v. Ministère de l'Économie, des Finances et de l'Industrie*, 2004 E.C.R. I-2409, ¶ 49; Case C-324/00, *Lankhorst-Hohorst GmbH v. Finanzamt Steinfurt*, 2002 E.C.R. I-11779, ¶ 33.

47. See Case C-324/00, *Lankhorst-Hohorst GmbH v. Finanzamt Steinfurt*, 2002 E.C.R. I-11779, ¶ 32 (“Such a difference in treatment between resident subsidiary companies according to the seat of their parent company constitutes an obstacle to the freedom of establishment which is, in principle, prohibited by Article 43 EC. The tax measure in question in the main proceedings makes it less attractive for companies established in other Member States to exercise freedom of establishment and they may, in consequence, refrain from acquiring, creating or maintaining a subsidiary in the State which adopts that measure.”).

ries: those that are enumerated in the Treaty (such as public policy, public security and public health, enumerated in Article 46) and unenumerated objectives relating to the general interest.⁴⁸ Direct tax cases challenging freedom of movement have seen a series of common justifications to defend Member State measures, including prevention of the diminution of tax receipts, maintaining the cohesion of the tax system, balancing the allocation of taxing rights between Member States, territoriality, prevention of the double use of losses, ensuring the effectiveness of fiscal supervision and prevention of tax avoidance.⁴⁹ Member States bear the burden of raising justifications,⁵⁰ and they will often raise multiple justifications in order to protect the measure in question.⁵¹ The court has accepted prevention of tax avoidance as a legitimate justification.⁵²

48. See Angelette, *supra* note 6, at 1219.

49. For justifications that apply in free movement cases other than those dealing with direct taxation, see Case C-386/04, *Centro di Musicologia Walter Stauffer v. Finanzamt München für Körperschaften*, 2006 E.C.R. I-08203, ¶ 43.

50. Case C-522/04, *Comm'n v. Belgium*, 2007 E.C.R. I-05701, ¶ 48.

51. Case C-524/04, *Test Claimants in the Thin Cap Group Litig. v. Comm'rs of Inland Revenue*, 2007 E.C.R. I-02107, ¶ 65; Case C-446/03, *Marks & Spencer plc v. David Halsey (HM Inspector of Taxes)*, 2005 E.C.R. I-10837.

Preventing the diminution of tax receipts has been held to be an insufficient justification. See Case C-386/04, *Centro di Musicologia Walter Stauffer v. Finanzamt München für Körperschaften*, 2006 E.C.R. I-08203, ¶ 59; Case C-196/04, *Cadbury Schweppes plc v. Comm'rs of Inland Revenue*, 2006 E.C.R. I-07995, ¶ 49; Case C-9/02, *Hughes de Lasteyrie du Saillant v. Ministère de l'Économie, des Finances et de l'Industrie*, 2004 E.C.R. I-2409, ¶ 60; Case C-436/00, *X&Y v. Riksskatteverket*, 2002 E.C.R. I-10829, ¶ 46. The Advocate General in *Cadbury Schweppes* suggested that this conclusion follows logically from the freedom of establishment. Opinion of Mr. Advocate Gen. Léger, Case C-196/04, *Cadbury Schweppes plc v. Comm'rs of Inland Revenue*, 2006 E.C.R. I-07995, ¶ 51. *But see* Tom O'Shea, *News Analysis: Finland's Intragroup Financial Transfer Rules Compatible with EU Law*, 47 TAX NOTES INT'L 634 (2007) (stating that Court made clear in *Centros* that this principle of taxpayers being permitted to choose their jurisdiction for tax purposes does not extend to situations of fraudulent conduct or tax avoidance).

The court, however, seems to have accepted the possibility that many of the others could be legitimate justifications if sufficiently limited. See Kingston, *supra* note 36, at 1347 (stating that the Court has an "extremely restrictive" attitude to justifications).

For cases addressing cohesion (also referred to as fiscal coherence), see Case C-524/04, *Test Claimants in the Thin Cap Group Litig. v. Comm'rs of Inland Revenue*, 2007 E.C.R. I-02107, ¶ 68; Case C-324/00, *Lankhorst-Hohorst GmbH v. Finanzamt Steinfurt*, 2002 E.C.R. I-11779, ¶ 40. *But see* Case C-478/98, *Comm'n v. Belgium*, 2000 E.C.R. I-0758, ¶¶ 34–35 (not accepting cohesion as a justification). Courts previously required that there be a direct link between the tax advantage and the tax in question, *see, e.g.*, *Joined Cases C-397/98 and C-410/98, Metallgesellschaft Ltd. v. Comm'rs of Inland Revenue*, 2001 E.C.R. I-1727, ¶ 69, but the court now seems to be "quietly dropping the requirement that the tax advantage and levy should relate to the same tax and taxpayer." Kingston, *supra* note 36, at 1348–49. Kingston states that "no-one is quite sure what is required in order for a

A measure will only be justified by this rationale, however, if it is sufficiently narrow to be found proportionate in the third prong of the three-part test. Although the court does not provide specific guidance on what is required for a measure to be proportionate to the Member State's justification, the wholly artificial arrangements doctrine grew out of the principle of proportionality in EU law. Before the ECJ explicitly applied the three-part framework described above

measure to fall under the justification." *Id.* at 1348.

For cases addressing balanced allocation, see Case C-347/04, *Rewe Zentralfinanz eG v. Finanzamt Köln-Mitte*, 2007 E.C.R. I-02647, ¶ 41. The interaction of balanced allocation with other justifications is unclear. Zalasinski suggests that balanced allocation may only be a legitimate justification when bundled with other justifications. Adam Zalasinski, *Proportionality of Anti-Avoidance and Anti-Abuse Measures in the ECJ's Direct Tax Case Law*, 35 *INTERTAX* 310, 320 (2007). In *Oy AA*, the court suggested that this justification is linked to prevention of tax avoidance. See O'Shea, *supra*.

For cases addressing territoriality, see Case C-250/95, *Futura Participations & Singer v. Admin. des contributions*, 1997 E.C.R. I-2471, ¶ 22. *But see* Case C-347/04, *Rewe Zentralfinanz eG v. Finanzamt Köln-Mitte*, 2007 E.C.R. I-02647, ¶ 68 (rejecting territoriality as a justification).

For cases addressing the double use of losses, see Case C-374/04, *Test Claimants in Class IV of the ACT Group Litig. v. Comm'rs of Inland Revenue*, 2006 E.C.R. I-11673, ¶¶ 51–52. This was also a legitimate justification in *Marks & Spencer*, but it was one of three justifications, so its independent legitimacy is still unclear. Case C-446/03, *Marks & Spencer plc v. David Halsey (HM Inspector of Taxes)*, 2005 E.C.R. I-10837, ¶ 51. *But see* Case C-347/04, *Rewe Zentralfinanz eG v. Finanzamt Köln-Mitte*, 2007 E.C.R. I-02647, ¶¶ 45–49 (rejecting the prevention of the double use of losses as irrelevant); Case C-374/04, *Test Claimants in Class IV of the ACT Group Litig. v. Comm'rs of Inland Revenue*, 2006 E.C.R. I-11673, ¶ 54 (delineating limit to use of this justification). This justification grows out of the Community principle of eliminating double taxation. See Council Directive 90/435/EEC, 1990 O.J. (L 225). For cases addressing the effectiveness of fiscal supervision, see Case C-250/95, *Futura Participations & Singer v. Admin. des contributions*, 1997 E.C.R. I-2471; Case 120/78, *Rewe-Zentral AG v. Bundesmonopolverwaltung für Branntwein (Cassis de Dijon)*, 1979 E.C.R. 649. *But see* Kingston, *supra* note 36, at 1351–52 (stating that, although this justification was accepted in *Futura Participations* early on, it never succeeds at protecting a measure through the third step).

52. This perhaps builds on the Community opposition to tax avoidance enshrined in Council Directive 77/799/EEC (now 92/12/EEC), which encourages information-sharing to prevent such avoidance. See Council Directive 92/12/EEC, 1992 O.J. (L 76); Opinion of Advocate Gen. Mischo, Case C-436/00, *X & Y v. Riksskatteverket*, 2002 E.C.R. I-10829, ¶¶ 48–49. See also Zalasinski, *supra* note 51, at 316 (stating that prevention of tax avoidance was legitimized in *ICI*).

Although accepting prevention of tax avoidance as a justification seems inconsistent with the court's refusal to accept prevention of diminishing tax receipts, see MASON, *supra* note 5, at 110, the court's move here could be understood as requiring narrower justifications (since the latter justification could apply to many more measures) or focusing as much on the negative externalities of tax avoidance as on its revenue-lowering potential.

to its analysis of alleged restrictions on the fundamental freedoms, the court arrived at a similar analysis by way of the principle of proportionality. Although the concept of proportionality was established in Article 5, which limits EU action to that which “is necessary to achieve the objectives of [the] Treaty,”⁵³ the principle of proportionality developed in the wake of *Cassis de Dijon*, the ECJ’s 1979 judgment that expanded the scope of the EC Treaty from facially discriminatory rules to nondiscriminatory rules that had the effect of discriminating between Member States.⁵⁴ In exchange for expanding its power to limit Member State actions under the EC Treaty, the ECJ allowed Member States to argue that their restrictions were justified.⁵⁵ The ECJ only held restrictions to be justified, however, if they were proportional, and proportionality was determined under a two-part test, according to which proportionality required that: (i) the restriction was appropriate for achieving the Member State’s stated objective and (ii) the restriction was not broader than necessary to achieve the stated objective (including, in certain cases, an analysis of whether another less restrictive measure was available).⁵⁶ In applying this test, the court does not provide clear guidance on what fulfills either of these requirements, instead stating generally that a measure “must comply with the principle of proportionality, in that it must be appropriate for securing the attainment of the objective it pursues and must not go beyond what is necessary to attain it.”⁵⁷

In 1998, without explanation for the change, the court shifted from applying the general principle of proportionality to referring specifically to wholly artificial arrangements when considering anti-avoidance cases. In the ensuing decade, the court has applied the wholly artificial arrangements doctrine to eleven anti-avoidance cas-

53. EC Treaty, *supra* note 8, art. 5. See, e.g., Charles E. McLure, Jr., *The Long Shadow of History: Sovereignty, Tax Assignment, Legislation, and Judicial Decisions on Corporate Income Taxes in the US and the EU*, in *COMPARATIVE FISCAL FEDERALISM: COMPARING THE EUROPEAN COURT OF JUSTICE AND THE US SUPREME COURT’S TAX JURISPRUDENCE* 119, 125 (Reuven S. Avi-Yonah et al. eds., 2007) (“Article 5 of the EC Treaty requires respect for *subsidiarity* and *proportionality*.”) (italics in original).

54. Case 120/78, *Rewe-Zentral AG v. Bundesmonopolverwaltung für Branntwein* 1979 E.C.R. 649.

55. *Zalasiński*, *supra* note 51, at 312.

56. For the sake of clarity, this Article focuses solely on the two-part test. The Court has also applied a three-part proportionality test that essentially breaks the second prong in two. *Id.* at 311–12. For examples of earlier direct tax cases applying the principle of proportionality, see Case C-478/98, *Comm’n v. Belgium*, 2000 E.C.R. I-07587 and Case C-334/02, *Comm’n v. France*, 2004 E.C.R. I-2229.

57. Case C-478/98, *Comm’n v. Belgium*, 2000 E.C.R. I-07587, ¶ 41.

es.⁵⁸ Under the wholly artificial arrangements doctrine, the court has replaced the balancing test inherent in the principle of proportionality with the requirement that a Member State's anti-avoidance measure may limit freedom of movement if it applies *only* to wholly artificial arrangements. A measure that applies to any transaction or situation that the court does not deem to be a wholly artificial arrangement is invalid as an impermissible limitation on the freedom of movement.

The majority of cases in which the court has applied the doctrine have led to the disallowance of the Member State anti-avoidance measure, effectively preventing the Member State from policing tax avoidance to the extent desired by the domestic legislature and revenue authority. The phrase "wholly artificial arrangements" first appeared in *ICI v. Colmer*, which invalidated the United Kingdom's restriction on the ability of parent companies to take their subsidiaries' losses into account.⁵⁹ Under the United Kingdom's corporate tax code, such losses could only be used by a parent with a majority of subsidiaries resident in the United Kingdom. In analyzing whether this provision violated the freedom of establishment, the Court considered whether the United Kingdom's stated objective of preventing tax avoidance justified the provision. The court rejected this claim, stating that it was sufficient to "note that the legislation at issue in the main proceedings does not have the specific purpose of preventing wholly artificial arrangements, set up to circumvent United Kingdom tax legislation, from attracting tax benefits."⁶⁰ The ECJ

58. As of August 2008, with two exceptions, the doctrine has only been applied in anti-avoidance cases. Those two exceptions, Case C-251/06, *Firma ING AUER — Die Bausoftware GmbH v. Finanzamt Freistadt Rohrbach Urfaahr*, 2007 E.C.R. I-09689, and Case C-162/07, *Ampliscientifica Srl & Amplifin SpA v. Ministero dell'Economia e delle Finanze & Agenzia delle Entrate*, 2008 E.C.R. I-04019, both decided within a year of August 2008, provide further evidence of the establishment of the wholly artificial arrangements doctrine. Both cases consider secondary legislation—*Firma ING AUER* applies Council Directive 69/335/EEC (amended by Directive 85/303/EEC), on capital duties, while *Ampliscientifica* applies Sixth Council Directive 77/388/EEC, on VAT—but both refer to the doctrine as established law. In *Firma ING AUER*, the court stated that the scope of the directive in question is not so broad as to protect "the formation of a company in a Member State under wholly artificial arrangements which do not reflect economic reality . . ." Case C-251/06, 2007 E.C.R. I-09689, ¶ 44. In *Ampliscientifica*, the court stated that the abuse of law principle prohibits the directive in question from protecting the formation of the same. Case C-162/07, E.C.R. I-4019, ¶ 28. Neither case does more than cite to earlier uses of the doctrine, but they do show that the wholly artificial arrangements doctrine had by August 2008 become sufficiently established to be cited outside of its area of origination.

59. Case C-264/96, *Imperial Chemical Industries plc (ICI) v. Kenneth Hall Colmer (HM Inspector of Taxes)*, 1998 E.C.R. I-4695.

60. *Id.* ¶ 26.

in *ICI* rejected the Member State's justification and struck down the legislation as a violation of freedom of establishment.

This trend continued in five more cases. In *Lankhorst-Hohorst GmbH v. Finanzamt Steinfurt*, decided in 2002, the Court struck down Germany's thin capitalization rules.⁶¹ In 2007, in *Rewe Zentralfinanz eG v. Finanzamt Köln-Mitte*, the Court struck down a provision of the German corporate tax code that limited the ability of resident parent companies to take write-downs into account if the write-downs were associated with a non-resident subsidiary, but not if the write-downs were associated with a resident subsidiary.⁶² The court added a wrinkle to this habit of using the doctrine to strike down Member State anti-avoidance rules in three of the cases in which it found the measure in question to be an impermissible violation of the freedom of movement. In these cases, the ECJ proposed changes that would make the measure more likely to survive application of the wholly artificial arrangements doctrine. In *Hughes de Lasteyrie du Saillant v. Ministère de l'Economie, des Finances et de l'Industrie*, decided in 2003, the court struck down a French tax provision that taxed residents on latent increases in value when they became non-residents,⁶³ but suggested that an alternative would be for the government to "provide for the taxation of taxpayers returning to France after realizing their increases in value during a relatively brief stay in another Member State."⁶⁴ Other cases in which the court struck down a measure but suggested ways to modify the measure in question to ensure that it applied only to wholly artificial arrangements include *Européenne et Luxembourgeoise d'investissements SA (ELISA) v. Directeur général des impôts et Ministère public*⁶⁵ and *Lammers & Van Cleeff NV v. Belgisch Staat*,⁶⁶ decided in 2007 and 2008, respectively. In *ELISA*, the court struck down a French law limiting an exemption from the tax on the commercial value of im-

61. Case C-324/00, *Lankhorst-Hohorst GmbH v. Finanzamt Steinfurt*, 2002 E.C.R. I-11779, ¶ 37.

62. Case C-347/04, *Rewe Zentralfinanz eG v. Finanzamt Köln-Mitte*, 2007 E.C.R. I-02647, ¶ 52.

63. The provision in question meant that a resident who owned property in France was taxed on the appreciation of value in that property when the resident moved outside of France, even if that appreciation was not realized. The provision did not apply to French residents who stayed within France or non-residents.

64. Case C-9/02, *Hughes de Lasteyrie du Saillant v. Ministère de l'Economie, des Finances et de l'Industrie*, 2004 E.C.R. I-2409, ¶ 54.

65. Case C-451/05, *Européenne et Luxembourgeoise d'investissements SA (ELISA) v. Directeur général des impôts, Ministère public*, 2007 E.C.R. I-08251.

66. Case C-105/07, *Lammers & Van Cleeff NV v. Belgische Staat*, 2008 E.C.R. I-00173.

movable property to persons with centers of management in France or in Member States that had signed a relevant tax treaty with France. The court suggested that the measure would have been permitted if non-residents who were residents of Member States with which France had not signed a relevant tax treaty were permitted under the measure to “provide documentary evidence to establish the identity of their shareholders and any other information which the French tax authorities consider to be necessary” for the purpose of “demonstrating that their objective is not that of tax evasion.”⁶⁷ In *Lammers*, the court struck down a Belgian law that reclassified interest payments above a certain level as a dividend when paid by a resident company to a non-resident director, but suggested that the law may have been acceptable if, before reclassifying all interest payments made to non-resident companies that exceed a certain limit, the measure provided for a determination of whether the interest being paid was for a loan granted on an arm’s length basis.⁶⁸

The court has also arrived at the opposite conclusion when applying the wholly artificial arrangements doctrine and upheld a domestic anti-avoidance measure as justified and proportional. In *Oy AA*, the court upheld the Finnish Law on Intra-Group Financial Transfers, even after finding that this law was a restriction on freedom of movement.⁶⁹ The court acknowledged the risk that, “by means of purely artificial arrangements, income transfers may be organised within a group of companies towards companies established in Member States applying the lowest rates of taxation or in Member States in which such income is not taxed.”⁷⁰ The court found that, were intra-group transfers deductible even when those transfers crossed borders, such an arrangement would allow groups of companies to jurisdiction-shop and choose the Member State in which their profits would be taxed, regardless of where those profits were generated.⁷¹ Based on this finding, the court held that there was no nar-

67. *ELISA*, 2007 E.C.R. I-08251, ¶¶ 98–100.

68. *Lammers*, 2008 E.C.R. I-00173, ¶¶ 29–33.

69. Case C-231/05, *Oy AA*, 2007 E.C.R. I-06373, ¶¶ 33–39. The ECJ currently uses “wholly artificial arrangements” and “purely artificial arrangements” interchangeably, often citing to a use of one when defining the other. While it is possible that these two phrases will come to have different meanings as the doctrine develops, the ECJ’s current jurisprudence provides no reason to believe that this will happen, and this Article therefore uses “purely artificial arrangements” as a synonym for “wholly artificial arrangements.” Due to the significant disparity in frequency of usage, however, with the ECJ much preferring “wholly” to “purely,” any use of the terms that is not quoting the ECJ directly will use the term “wholly artificial arrangements” to refer to both phrases.

70. *Id.* ¶ 58.

71. *Id.* ¶ 64.

rower way of preventing such a situation, and it thus upheld the Finnish Law on Intra-Group Financial Transfers.⁷²

Earlier, in *Marks & Spencer plc v. David Halsey*,⁷³ the court also upheld the law in question, but it did so conditionally. In *Marks & Spencer*, the court considered the United Kingdom's group tax relief provisions and allowed them to stand only if they met two criteria.⁷⁴ Although the court presented its decision as upholding the measure in question, it effectively conditioned this finding by providing the domestic court with guidance for applying the wholly artificial arrangements doctrine and making a final decision. This deferral has occurred in the three other anti-avoidance cases in which the court applied the doctrine. In all three cases in which the court allowed the domestic court to make the final decision, the court has provided the domestic court with guidelines for determining whether the measure in question applies only to wholly artificial arrangements. In *Cadbury Schweppes plc v. Commissioners of Inland Revenue*,⁷⁵ the ECJ considered the United Kingdom's CFC provisions. These provisions included a motive test, which exempted parent companies from the provisions when they could show that the purpose of the transactions in question and the nonresident subsidiaries were not primarily to reduce the taxes paid to the United Kingdom.⁷⁶ Rather than deciding whether the motive test was sufficient to limit the transactions that the CFC rules targeted to wholly artificial ar-

72. *Id.* ¶¶ 65–67.

73. Case C-446/03, *Marks & Spencer plc v. David Halsey* (HM Inspector of Taxes), 2005 E.C.R. I-10837.

74. The Court required that the provisions if they allowed for non-resident subsidiary's losses being taken into account when the following two criteria were met:

- the non-resident subsidiary has exhausted the possibilities available in its State of residence of having the losses taken into account for the accounting period concerned by the claim for relief and also for previous accounting periods, if necessary by transferring those losses to a third party or by offsetting the losses against the profits made by the subsidiary in previous periods, and

- there is no possibility for the foreign subsidiary's losses to be taken into account in its State of residence for future periods either by the subsidiary itself or by a third party, in particular where the subsidiary has been sold to that third party.

Id. ¶ 55.

75. Case C-196/04, *Cadbury Schweppes plc v. Comm'rs of Inland Revenue*, 2006 E.C.R. I-07995.

76. The United Kingdom CFC provisions at issue in *Cadbury Schweppes* were significantly more complicated than the ECJ suggested in its decision. For a more detailed description of the provisions, see Simon Whitehead, *Practical Implications Arising From the European Court's Recent Decisions Concerning CFC Legislation and Dividend Taxation*, 4 EC TAX REV. 176, 176–78 (2007).

rangements, the court left the ultimate decision to United Kingdom courts and provided them with the following criteria:

[I]n order for the legislation on CFCs to comply with Community law, the taxation provided for by that legislation must be excluded where, despite the existence of tax motives, the incorporation of a CFC reflects economic reality.

That incorporation must correspond with an actual establishment intended to carry on genuine economic activities in the host Member State

As suggested by the United Kingdom Government and the Commission at the hearing, that finding must be based on objective factors which are ascertainable by third parties with regard, in particular, to the extent to which the CFC physically exists in terms of premises, staff and equipment.

If checking those factors leads to the finding that the CFC is a fictitious establishment not carrying out any genuine economic activity in the territory of the host Member State, the creation of that CFC must be regarded as having the characteristics of a wholly artificial arrangement. That could be so in particular in the case of a "letterbox" or "front" subsidiary.⁷⁷

The court again left the final application of the wholly artificial arrangements doctrine to a national court in *Test Claimants in the Thin Cap Group Litigation v. Commissioners of Inland Revenue (Thin Cap GLO)*, in which the court considered several test cases challenging the United Kingdom's thin capitalization rules prior to the 1995 amendments and after the 1995 and 1998 amendments.⁷⁸ The court stated that the national court should find that the rules were sufficiently narrow if they met three separate criteria.⁷⁹ Finally, in

77. *Cadbury Schweppes*, 2006 E.C.R. I-07995, ¶¶ 65–68. For the domestic court's finding, see *infra* notes 118–27 and accompanying text.

78. After the decision in *Lankhorst-Hohorst GmbH*, 2002 E.C.R. I-11779, striking down Germany's thin capitalization rules, a number of claims were brought before United Kingdom courts by corporations requesting restitution or compensation. As part of this group litigation, the national court selected certain test cases to refer to the ECJ for a preliminary ruling. The test cases all involved a resident company that was at least 75% owned by a non-resident parent company and that had been granted a loan either by the parent company or another non-resident company at least 75% owned by the parent company.

79. The Court required that the rules: (i) only treated interest payments from a resident

Test Claimants in the CFC and Dividend Group Litigation v. Commissioners of Inland Revenue (CFC Test Claimants), the court considered the United Kingdom's CFC rules after *Cadbury* and disallowed the rules unless they met certain requirements.⁸⁰ The determination of whether these criteria were met was left to the national court.

The ECJ's application of the wholly artificial arrangements thus leads to a variety of outcomes. The holdings of the eleven cases discussed above are presented visually in the table below:

subsidiary to a non-resident parent company as a distribution when the payments exceed what the companies would have agreed to on an arm's length basis, (ii) taxed as a distribution only the proportion of the interest payment that exceeded what would have been agreed to in an arm's length transaction, and (iii) provided taxpayers with the opportunity to produce evidence of the commercial justifications for the transaction if the arrangement did not satisfy the arm's length principle. Case C-524/04, *Test Claimants in the Thin Cap Group Litig. v. Comm'rs of Inland Revenue*, 2007 E.C.R. I-02107, ¶¶ 80–87. The court stated that the arm's length principle provided “an objective element which can be independently verified in order to determine whether the transaction in question represents, in whole or in part, a purely artificial arrangement, the essential purpose of which is to circumvent the tax legislation of that Member State.” *Id.* ¶ 81.

80. Twenty-one groups of international companies brought claims challenging the United Kingdom provisions on dividends and CFCs, and the claims of three of these groups—Anglo-American, Cadbury Schweppes and Prudential—were selected as test cases. These test groups claimed that they would not have paid the taxes required under these provisions or expended the cost required to comply with these provisions had they known that the provisions were contrary to Community law. Case C-201/05, *Test Claimants in the CFC and Dividend Group Litig. v. Comm'rs of Inland Revenue*, 2008 E.C.R. I-02875, ¶¶ 25–30. The court considered other United Kingdom direct tax provisions, but it only applied the wholly artificial arrangements doctrine in its analysis of the CFC rules. Note that, because the court had already ruled on an identical question in *Cadbury*, it issued a reasoned order, rather than an opinion.

The court order includes discussion of two questions: (i) whether freedom of movement precludes legislation that provides for the inclusion in the tax base of a resident company of profits made by a CFC resident in a lower-tax Member State and (ii) whether freedom of movement precludes compliance requirements when a resident company seeks exemption from taxes already paid in the non-resident company's Member State of residence. *Id.* ¶ 70. The Court (i) disallowed CFC rules *unless* they applied “only to wholly artificial arrangements intended to escape the national tax normally payable” as determined by objective factors and (ii) allowed compliance requirements *as long as* their purpose was “to verify that the CFC is actually established and that its economic activities are genuine without that entailing undue administrative constraints.” *Id.* ¶¶ 85–86.

TABLE A: European Court of Justice Anti-Avoidance Cases
Applying the Wholly Artificial Arrangements Doctrine

	Court strikes down measure	Court leaves the decision to the national court	Court upholds measure as justified and proportional
<i>ICI</i>	X		
<i>Lankhorst-Hohorst</i>	X		
<i>Lasteyrie du Saillant</i>	X ^(a)		
<i>Marks & Spencer</i>			X ^(b)
<i>Cadbury</i>		X ^(c)	
<i>Thin Cap GLO</i>		X ^(c)	
<i>Rewe</i>	X		
<i>Oy AA</i>			X
<i>ELISA</i>	X ^(a)		
<i>Lammers</i>	X ^(a)		
<i>CFC Test Claimants</i>		X ^(c)	

- (a) Court proposes changes that would make the measure more likely to be upheld
- (b) Court only upholds measure if it is limited
- (c) Court provides specific criteria that national court should consider

III. PROBLEMS AND PERILS WITH THE WHOLLY ARTIFICIAL ARRANGEMENTS DOCTRINE

As outlined above, the majority of cases applying the wholly artificial arrangements doctrine either strike down the challenged Member State anti-avoidance rule or provide guidelines or conditions for the application of the doctrine. Rather than allowing the anti-avoidance rule in question to stand, these cases thus either invalidate the rule or impose limitations that the Member State had not previously imposed on itself. Because the wholly artificial arrangements doctrine thus sets the outer limits for permissible anti-avoidance rules throughout the EU, this Article argues that it is effectively an anti-

avoidance doctrine or a principle of limitation that applies to domestic anti-avoidance rules. This Part first contextualizes this assertion by discussing various anti-avoidance doctrines before critiquing the wholly artificial arrangements doctrine along three separate dimensions.

Although the many specific rules discussed in Part II, from CFC provisions to thin capitalization rules, are becoming more popular in many jurisdictions, they are not the only tools available to revenue authorities to combat tax avoidance. While courts and revenue authorities rely on rules to prevent tax evasion, they use a combination of rules and standards to combat tax avoidance.⁸¹ As tax avoidance becomes progressively more complex and creative, revenue authorities are not always able to preemptively rule on what is or is not tax avoidance. Judicially created anti-avoidance doctrines fill this void and allow courts to determine *ex post* whether a tax avoidance scheme that may not have been foreseen by the drafters of the revenue code in fact violates the spirit of the code.

To better place the wholly artificial arrangements doctrine in its proper context, this Part introduces readers to judicially-created anti-avoidance doctrines. Anti-avoidance doctrines exist apart from statutory rules and are used by courts to deny tax benefits that arise from unacceptable avoidance, even when the transaction or arrangement giving rise to these benefits is not prohibited by the letter of the law.⁸² Anti-avoidance doctrines are often used by courts to reinterpret the tax rules as written when the result of those rules would vi-

81. This Article uses the Kaplow definition of rules and standards, pursuant to which rules are given content *ex ante* and standards are given content *ex post*. See Louis Kaplow, *Rules Versus Standards: An Economic Analysis*, 42 DUKE L.J. 557, 560 (1992) (defining rules and standards such that “the only distinction between rules and standards is the extent to which efforts to give content to the law are undertaken before or after individuals act”) (emphasis omitted).

82. Anti-avoidance standards include United States common law doctrines such as the substance over form, step transaction, business purpose, sham transaction and economic substance doctrines. Joseph Bankman, *The Economic Substance Doctrine*, 74 S. CAL. L. REV. 5, 5 (2000). They also include the now defunct Ramsay principle in the United Kingdom and the abuse of law principle in certain Member States. See Yitzhak Hadari, *Tax Avoidance in Linear Transactions: The Dilemma of Tax Systems*, 15 U. PA. J. INT’L BUS. L. 59 (1994) (comparing anti-avoidance doctrines in Israel, the United Kingdom, and the United States); Nicola Preston, *The Interpretation of Taxing Statutes: The English Perspective*, 7 AKRON TAX J. 43, 47–59 (1990) (charting the development and interpretation of the principle first established in *W.T. Ramsay Ltd. v. Inland Revenue Comm’rs*, [1982] A.C. 300 (H.L.), pursuant to which a court can look to the substance of certain transactions to determine their validity).

olate courts' sense of the ultimate goal of the tax rules.⁸³ All judicial anti-avoidance doctrines essentially play an override function, pursuant to which they disregard the statutorily permitted tax benefits and instead consider the purpose and effect of a transaction to determine whether those benefits should be allowed.⁸⁴ Anti-avoidance doctrines are thus standards that are created and applied by judges,⁸⁵ while anti-avoidance rules, as with all statutes and rules, are created by legislatures and their application is arguably less dependent on a judge's discretion.

Two illustrative examples of anti-avoidance doctrines are the economic substance doctrine in the United States and the abuse of law principle in the EU. The economic substance doctrine, which prohibits transactions that would otherwise be permitted under the Code if those transactions lack economic substance, is one of the most discussed anti-avoidance doctrines. First applied in 1934,⁸⁶ this doctrine continues to spark debate over its definition and scope, with even the meaning of economic substance undefined.⁸⁷ The economic substance doctrine does not apply to any one specific provision of the Code. Instead, courts look for economic substance—or lack thereof—in a variety of transactions that are covered by a number of different Code provisions. When applying the doctrine in various situations, courts differ on everything from the definition of economic substance to the level of tax avoidance permitted under the Code.⁸⁸

83. See David A. Weisbach, *An Economic Analysis of Anti-Tax-Avoidance Doctrines*, 4 AM. L. & ECON. REV. 88, 94–95 (2002) (describing anti-avoidance doctrines as “standards that override the otherwise applicable statutory rules”). This Article will not address the benefit of rules versus standards. For more on that debate in the context of tax law, see Kaplow, *supra* note 81, and Weisbach, *supra*. Kaplow argues that rules should be used where the law applies frequently.

84. See Tim Edgar, *Building a Better GAAR*, 27 VA. TAX REV. 833, 875–77 (2008).

85. Although anti-avoidance doctrines are created by judges and act as the basis for certain judicial opinions, they are also asserted by litigants once they become accepted parts of the tax law in a jurisdiction.

86. *Helvering v. Gregory*, 69 F.2d 809 (2d Cir. 1934), *aff'd*, 293 U.S. 465 (1935).

87. See Charlene D. Luke, *Risk, Return, and Objective Economic Substance*, 27 VA. TAX REV. 783, 787 (2007–2008) (stating that “[t]he precise structure of the economic substance doctrine is not settled . . .”); see also Sandra Favelukes O’Neill, *Let’s Try Again: Reformulating the Economic Substance Doctrine*, 121 TAX NOTES 1053, 1053–54 (2008) (stating that “[t]he historical articulation of the economic substance doctrine demonstrates that, at its essence, the doctrine is one of purposeful statutory construction”).

88. For different courts’ applications of the economic substance doctrine, see, for example, *United Parcel Serv. v. Comm’r*, 254 F.3d 1014, 1019 (11th Cir. 2001) (“A ‘business purpose’ does not mean a reason for a transaction that is free of tax considerations.”); *ACM P’ship v. Comm’r*, 157 F.3d 231, 247 (3d Cir. 1998) (stating that the “inquiry into whether the taxpayer’s transactions [have] sufficient economic substance to be

In contrast to the economic substance doctrine, which applies solely within the context of taxation, abuse of law is a principle that originated outside of tax law. In civil law countries, the majority of Member States, tax avoidance is closely related to—and sometimes subsumed by—the principle of abuse of law.⁸⁹ Abuse of law is a civ-

respected for tax purposes turns on both the 'objective economic substance of the transactions' and the 'subjective business motivation' behind them. However, these distinct aspects of the economic sham inquiry do not constitute discrete prongs of a 'rigid two-step analysis,' but rather represent related factors both of which inform the analysis of whether the transaction has sufficient substance, apart from its tax consequences, to be respected for tax purposes.") (citation omitted); *Friedman v. Comm'r*, 869 F.2d 785 (4th Cir. 1989); *Sochin v. Comm'r*, 843 F.2d 351, 354 (9th Cir. 1988); *Rosenfeld v. Comm'r*, 706 F.2d 1277, 1281 (2d Cir. 1983) ("[A] transaction which is otherwise legitimate, is not unlawful merely because an individual seeks to minimize the tax consequences of his activities."); *Salina P'ship v. Comm'r*, 80 T.C.M. (CCH) 686, 694 (2000) ("It is well settled that taxpayers generally are free to structure their business transactions as they please, even if motivated by tax avoidance considerations."). For more detailed criticism of the economic substance doctrine, see, e.g., Joseph Bankman, *The Business Purpose Doctrine and the Sociology of Tax*, 54 SMU L. REV. 149 (2001); Bankman, *supra* note 82, at 11; David P. Hariton, *Sorting Out the Tangle of Economic Substance*, 52 TAX LAW 235 (1999); Yoram Keinan, *The Many Faces of the Economic Substance's Two-Prong Test: Time for Reconciliation?*, 1 N.Y.U. J. L. & BUS. 371, 373 (2005); Luke, *supra* note 87, at 787; O'Neill, *supra* note 87.

89. It should be noted at the outset that there is an ongoing debate over whether abuse of law has risen to the level of an actual principle of EU law. Some commentators claim that it is a concept that is "evol[ing] towards a general principle of law," Zalasinski, *supra* note 51, at 314, while others state that it is unclear both whether it is a "fully fledged principle" and, if it is, whether that principle applies to Community law or to domestic law throughout the Community, Rita de la Feria, *Prohibition of Abuse of (Community) Law: The Creation of a New General Principle of EC Law Through Tax*, 45 COMMON MKT. L. REV. 395, 397–98 (2008). If it is a principle, it may still be one that is "heavily dependent on the subject matter at issue," *id.* at 399, which itself raises the question of whether such an approach is actually a principle. For an example of different applications based on different contexts, see *id.* at 417 (stating that "the case law appears to suggest a divergence of approach by the ECJ to abuse in cases concerning purely commercial situations, namely those involving legal persons, from those involving natural persons"). For further discussion on the debate over whether abuse of law has reached principle status, see *id.* at 436–39. Feria posits that four main arguments have been presented in favor of abuse of law *not* being a principle of Community law: (i) the Court has never recognized the existence of such a principle, (ii) not all Member States apply abuse of law in their domestic courts, (iii) there is no precise Community definition of abuse of law and (iv) the Court is inconsistent in its application of abuse of law. She then argues, however, that these arguments have been weakened by recent tax rulings. *Id.* at 395–98. Since the ECJ recently referred to "the general Community law principle that abuse of rights is prohibited," Case C-321/05, *Kofoed v. Skatteministeriet*, 2007 E.C.R. I-5795 ¶ 38; see also Case C-255/02, *Halifax plc, Leeds Permanent Dev. Servs. Ltd & County Wide Prop. Invs. Ltd v. Comm'rs of Customs & Excise*, 2006 E.C.R. I-1609, ¶¶ 68–70, [hereinafter *Halifax*]. (referring to a "principle of prohibiting abusive practices"), for purposes of this Article, abuse of law will be treated as a principle. This does not,

il law concept.⁹⁰ The term generally includes avoidance of law in addition to the much narrower evasion of law, which includes only fraudulent and illegal actions, but its specific definition may change depending on the country applying the term.⁹¹ It first appeared in EU law in 1974, with the Court's reference to abusive practice in *Van Binsbergen*.⁹²

Abuse of law then made its way into the tax field by way of indirect taxation in the *Halifax* case, decided in 2006, which explicitly limited its reasoning to the VAT context.⁹³ The Court held that the principle of prohibiting abusive practices applied to VAT, and defined that principle to mean that the "application of Community legislation cannot be extended to cover abusive practices by economic operators, that is to say transactions carried out not in the context of normal commercial operations, but solely for the purpose of wrongfully obtaining advantages provided for by Community law."⁹⁴ The ECJ then established a two-part test to determine whether an abusive practice exists:

[I]n the sphere of VAT, an abusive practice can be found to exist only if, first, the transactions concerned, notwithstanding formal application of the conditions laid down by the relevant provisions of the Sixth Directive and the national legislation transposing it, result in the accrual of a tax advantage the grant of which would be contrary to the purpose of those provisions.

Second, it must also be apparent from a number of objective factors that the essential aim of the transactions concerned is to obtain a tax advantage. . . . [T]he prohibition of abuse is not relevant where the economic

however, mean that this Article considers the scope of this principle or its definition to be settled. See Marco Gregg, *Avoidance and abus de droit: The European Approach in Tax Law*, 6 E.JOURNAL OF TAX RESEARCH 23, 36 (2008) (stating that "no iron curtain runs between use and abuse of law, but rather a thin red line that can shape a different border when the abuse is tested under commercial law versus tax law").

90. de la Feria, *supra* note 89, at 395.

91. Gregg, *supra* note 89, at 33. For history on the concept of abuse of law, see *id.* at 25-34.

92. de la Feria, *supra* note 89, at 88 n.1 (citing Case 33/74, *Johannes Henricus Maria van Binsbergen v. Vestuur van de Bedrijfsvereniging voor de Metaalnijverheid* 1974 E.C.R. 1299).

93. *Halifax*, *supra* note 89, ¶ 74.

94. *Id.* ¶ 69.

activity carried out may have some explanation other than the mere attainment of tax advantages.⁹⁵

The Court left the decision of whether such an abusive practice existed to the national court, but it clarified that, when looking to the second criterion, a national court must “determine the real substance and significance of the transactions concerned. In so doing, it may take account of the *purely artificial nature* of those transactions and the links of a legal, economic and/or personal nature between the operators involved in the scheme for reduction of the tax burden.”⁹⁶ In a later case also addressing VAT, the Court clarified that “there can be a finding of an abusive practice when the accrual of a tax advantage constitutes the principal aim of the transaction or transactions at issue.”⁹⁷

In *Halifax*, therefore, the ECJ established that the principle of abuse of law applies within the field of indirect taxation, but it did not have to address whether abuse of law in the Community context refers to a prohibition on abuse of Community law or a Community-wide prohibition on abuse of domestic law.⁹⁸ Amongst commentators and practitioners, this question—and, in fact, the question of how to define abuse of law—remains unanswered. Some commentators are confident that the ECJ’s abuse of law focus is at the Community level⁹⁹ and others see a clear divide between abuse of Community law and abuse of domestic law,¹⁰⁰ while others highlight the overlap between the concepts.¹⁰¹

95. *Id.* ¶¶ 74–75.

96. *Id.* ¶ 81 (emphasis added).

97. Case C-425/06, Ruling, *Ministero dell’Economia e delle Finanze v. Part Service Srl.*, 2008 E.C.R. I-897 ¶ 1.

98. *See de la Feria, supra* note 89, at 397–98 (stating that this aspect of abuse of law is unclear).

99. Frans Vanistendael, Editorial, *Halifax and Cadbury Schweppes: One Single European Theory of Abuse in Tax Law?*, 15 EC TAX REV. 192, 194 (2006) (opining that “the ECJ has decided that in the field of income taxation national anti-avoidance or anti-abuse provisions can only be accepted in a cross-border context when they fight or prevent abuse of Community law, which is not necessarily the same as abuse of national law”).

100. *See Zalasinski, supra* note 51, at 314 (stating that “[t]ax avoidance, which appears in cases of the abusive use of tax provisions, should be distinguished from the abuse of EC rights”).

101. *See Greggi, supra* note 89, at 37 (That is why the Court plays a fundamental role in defining the notion and the condition of abuse: defining tax avoidance, it also contributes to defining the abuse of right by the Member State. In EU law this is particularly true: the abuse of the taxpayer is counterweighted by the abuse of the Member State; both subjects are, to a certain extent, in an equal position before the Court. *Cadbury* is paradigmatic to

Both the economic substance doctrine and the abuse of law principle highlight the uncertainty and unpredictability that plague anti-avoidance standards. They also, however, share the flexibility and ex post application that characterize these standards and that allow them to strike down tax avoidance that might otherwise be permitted in a world of only ex ante anti-avoidance rules. Although the wholly artificial arrangements doctrine applies to anti-avoidance rules, rather than to transactions, it is in effect similar to many of the anti-avoidance doctrines discussed above, in that it is a judicially created standard that is, like all standards, applied and interpreted ex post. Like other anti-avoidance doctrines, it benefits from flexibility but can easily be criticized for inconsistency. Unlike other anti-avoidance doctrines, however, it is not applied by courts in the face of potential tax avoidance. Instead, it is a supranational principle of limitation that is applied by the Court to determine the legitimacy of anti-avoidance rules in the face of potential discrimination or restriction on the fundamental freedoms of the EU. This Part will assess the impact of this evolving anti-avoidance doctrine from three separate perspectives: (i) taxpayers within the EU, (ii) Member States, and (iii) the EU legal order as a whole.

A. *Taxpayers and the Wholly Artificial Arrangements Doctrine*

Since the majority of decisions discussed in Part II led to the invalidation of the Member State anti-avoidance rule in question, taxpayers engaged in potential avoidance transactions are likely to favor this new doctrine. For taxpayers engaged in transactions that are not so egregious as to qualify as “wholly artificial” but that were previously prevented by domestic anti-avoidance provisions, therefore, the wholly artificial arrangements doctrine may come as a bless-

this extent. From the UK point of view, the taxpayer is abusing his right to set up an economic activity abroad, as far as his decision is basically inspired by tax deferral and tax reduction, and from the taxpayer point of view, the UK is abusing its right to override the Treaty freedoms. The concept of tax avoidance (and the closely related ‘abuse of law’) therefore is at a crossroads the Court had to regulate, potentially catching two pigeons with one seed.)

For an example of a commentator who considers the Court’s approach to abuse of law to be consistent, see Tom O’Shea, *Some ECJ Guidance on Abusive Tax Practices in the European Union*, 50 TAX NOTES INT’L 241 (Apr. 21, 2008) (arguing that *Part Service*, *Thin Cap GLO* and *Cadbury Schweppes* all exhibit ECJ’s consistent approach to abuse of law). For an example of a commentator who considers the Court’s approach to abuse of law to be inconsistent, see Pistone, *supra* note 35 (arguing that *Halifax*, *Cadbury Schweppes*, *Thin Cap* and *Kofoed* reveal inconsistencies in the Court’s approach to abuse of law).

ing. Despite this, the doctrine still raises three sets of concerns for taxpayers within the EU.

First, tax avoidance creates negative externalities,¹⁰² but it differs from other externality-creating behavior in that the economically ideal level of tax avoidance is zero.¹⁰³ In other words, it creates undesirable results that affect parties other than the taxpayer (or tax non-payer, as the case may be) engaged in the avoidance. These undesirable results include lower tax revenue, redistribution of wealth from the government to taxpayers without actual wealth generation, equity concerns and lack of confidence in the tax system as a whole.¹⁰⁴ Tax avoidance is generally understood to breed disrespect for the tax system and to lower taxpayer morale.¹⁰⁵ As tax avoidance increases—or as taxing jurisdictions become less willing or able to police and prevent such avoidance—taxpayers lose respect for the tax system. Whereas the effect of anti-avoidance doctrines such as the economic substance doctrine is to boost taxpayer morale, the effect of the wholly artificial arrangements doctrine is the opposite. Since the wholly artificial arrangements doctrine limits the ability of Member States to prevent tax avoidance, the doctrine has the potential to increase tax avoidance and thus lower taxpayer morale. As taxpayers lose respect for the tax system, they arguably become more likely to find ways to themselves avoid taxation, as well as becoming otherwise disengaged.

Second, avoidance reduces revenue. The creation of a doctrine that may lead to more tax avoidance threatens the ability of Member States to raise revenue and shape fiscal policy. As consumers of services funded by tax revenues, therefore, Member State taxpayers may be harmed by the wholly artificial arrangements doctrine.

102. Edgar, *supra* note 84, at 833. Although tax avoidance differs from more traditional negative externalities, thinking of it as such emphasizes its actual social costs, which will be discussed in greater detail in Part IV.

103. *Id.* at 864 (stating that “there is no level of tax-avoidance behavior that policymakers should accept”). Note that although an economically ideal level of tax avoidance would be zero, such a level is logistically and politically impossible.

104. Alexandra M. Walsh, Note, *Formally Legal, Probably Wrong: Corporate Tax Shelters, Practical Reason and the New Textualism*, 53 STAN. L. REV. 1541, 1543 (2001).

105. See, e.g., Dept. of the Treasury, *The Problem of Corporate Tax Shelters: Discussion, Analysis and Legislative Proposals* (1999), (Section IV noting that tax shelters “breed disrespect for the tax system—both by those who participate in the tax shelter market and by others who perceive unfairness”); Staff of the Joint Committee on Taxation, 97th Cong., General Explanation of the Revenue Provisions of the Tax Equity and Fiscal Responsibility Act of 1982 (H.R. 4961, Public Law 97-218) (Comm. Print 1982), 17 (stating that one purpose for passing the alternative minimum tax was that “the ability of high-income individuals to pay little or no tax undermines respect for the entire tax system”).

Finally, the wholly artificial arrangements doctrine as it currently exists is plagued by ambiguity and unpredictability.¹⁰⁶ Just as with anti-avoidance doctrines such as the economic substance doctrine and the abuse of law principle,¹⁰⁷ the inconsistencies of the wholly artificial arrangements doctrine lead to unpredictability, meaning that taxpayers are left without guidance as to the effect of the doctrine on their own tax burden. In none of the cases described in Part II does the Court define what constitutes a wholly artificial arrangement; it instead raises more questions than it answers. Is a wholly artificial arrangement determined by objective economic substance, subjective intent to avoid taxation, or a combination of the two?¹⁰⁸ Do wholly artificial arrangements only occur in tax evasive or fraudulent transactions, or do they also occur in tax avoidance

106. From the perspective of taxpayers, such unpredictability may not necessarily be enough of a problem to offset the fact that the doctrine limits the ability of Member States to police tax avoidance. Unpredictability does create more transaction costs for taxpayers structuring transactions, however, and is thus a problem inherent in the doctrine, even if these costs do not outweigh the benefits of a more permissive tax environment.

107. See *supra* notes 82–101 and accompanying text.

108. This confusion may originate partly in the court's abuse of law jurisprudence and partly in the court's response to the opinion of Advocate-General Léger that preceded the court's opinion by four months. See Case C-196/04, Opinion of Mr. Advocate General Léger, *Cadbury Schweppes plc v. Comm'rs of Inland Revenue*, 2006 E.C.R. I-7995. In tying the analysis of the wholly artificial arrangements doctrine in his opinion to both the abuse of law principle and the purposes behind the Treaty protection of freedom of establishment, Advocate-General Léger arrived at a determinative question: "whether there is a wholly artificial arrangement intended to circumvent national tax legislation in a parent company's relationship with a CFC" depends on "whether the subsidiary is genuinely established in the host State and carries on its activities in that State with regard to the services provided to the parent company, the payment for which has resulted in a tax reduction by that company in the State of origin." *Id.* ¶ 110. Léger proposed a three-part test, based on suggestions from the United Kingdom and the Commission, to determine whether a subsidiary satisfies the requirement of genuine establishment: "First, the degree of physical presence of the subsidiary in the host State, secondly, the genuine nature of the activity provided by the subsidiary and, finally, the economic value of that activity with regard to the parent company and the entire group." *Id.* ¶ 111. All three of these criteria would be determined "only on the basis of objective factors." *Id.* ¶ 117. See also *id.* ¶ 115 (rejecting the "parent company's avowed purpose of obtaining a reduction of its taxation in the State of origin" as a criterion). The court, however, did not adopt the three-part test and instead focused entirely on "objective factors which are ascertainable by third parties with regard, in particular, to the extent to which the CFC physically exists in terms of premises, staff and equipment" in determining the existence of a wholly artificial arrangement. *Cadbury Schweppes plc v. Comm'rs of Inland Revenue*, 2006 E.C.R. I-07995, ¶ 67. Furthermore, the court stated that such a wholly artificial arrangement required both "a subjective element consisting in the intention to obtain a tax advantage" and "objective circumstances showing that, despite formal observance of the conditions laid down by Community law, the objective pursued by freedom of establishment . . . has not been achieved." *Id.* ¶ 64.

transactions?¹⁰⁹ In other words, are Member States permitted to prevent anything other than purely fraudulent transactions in the wake of the wholly artificial arrangements doctrine? Finally, is it possible that the wholly artificial arrangements doctrine is not entirely limited to wholly artificial arrangements?¹¹⁰

109. This uncertainty may arise partially out of the uncertainty over what constitutes abuse of law. The EU as a whole lacks an agreement on the line between acceptable and unacceptable tax avoidance, and the court has continued this confusion by blurring the line between tax avoidance and tax evasion in its development of the wholly artificial arrangements doctrine. Although the European Council noted in 1975 the importance of combating international tax evasion and tax avoidance, *see* Council Resolution of 10 February 1975 on the measures to be taken by the Community in order to combat international tax evasion and avoidance, Council Resolution of 10 February 1975, 1975 O.J. (C 35) 1, 2, and the European Commission has focused in a recent communication on the problem of tax evasion, *see* Provisional communication of 26 October 2005 (*cited in* Paulus Merks, *Tax Evasion, Tax Avoidance and Tax Planning*, 34 *INTERTAX* 273, 277 n. 42 (2006)), the EU lacks a definition of tax avoidance or a clear line between what level of tax avoidance beyond tax evasion is acceptable. *Id.* at 277. Note that the Ruding Committee, a committee of experts convened by the European Commission, did provide a broad definition of tax avoidance, but this seems not to have been picked up by EU institutions, particularly the ECJ. *See id.* at 278. Tax avoidance and tax evasion are generally understood to be distinct concepts. Tax evasion refers to illegal activity, “which entails breaking the law and which moreover can be shown to have been taken with the intention of escaping payment of tax.” *Id.* at 273. Tax avoidance, in contrast, includes all efforts by taxpayers to reduce their tax burden and can include both acceptable avoidance and unacceptable avoidance. *Id.* at 273–74. For the purposes of this Article, unacceptable tax avoidance is that level of tax avoidance beyond pure fraudulent tax evasion that a taxing jurisdiction determines to be unacceptable. One example of tax avoidance, in contrast to tax evasion, could include transactions that obey the letter of the law but are structured so as to reduce taxation to an extent prohibited by the overarching purposes of the tax law. In *Lankhorst-Hohorst*, 2002 E.C.R. I-11779, the Court treated tax avoidance and tax evasion as interchangeable. In *ELISA*, 2007 E.C.R. I-08251, the Court alternated between distinguishing between them and conflating them. In *Cadbury Schweppes*, 2006 E.C.R. I-7995, the Court resorted to general references to abuse of law rather than clarifying exactly how much tax avoidance beyond tax evasion—if any—Member States are permitted to police.

110. The Court added to the confusion over the definition of wholly artificial arrangements when it suggested in one case that perhaps the doctrine does *not* require domestic anti-avoidance provisions to target *only* wholly artificial arrangements. In *Oy AA*, 2007 E.C.R. I-06373, the Court suggested that a measure could be proportionate to the justification of preventing tax avoidance even if it was not only meant to target wholly artificial arrangements. The Court in *Oy AA* appears to have broadened the range of domestic provisions that may withstand scrutiny under the wholly artificial arrangements doctrine. By stating that a measure intended to prevent tax avoidance may be permissible even if it is intended to target more transactions than wholly artificial arrangements created to avoid taxation, the Court suggested that such a measure could survive application of the wholly artificial arrangements doctrine. No later judgment has supported this view, however, so the scope of the doctrine—and the anti-avoidance rules that it encompasses—remains unclear to taxpayers.

Despite this uncertainty, taxpayers do have reason to believe that the effect of the doctrine is to allow more tax positions than were previously permitted under Member State anti-avoidance rules, since the doctrine has been used to strike down multiple such rules. The Court has used the wholly artificial arrangements doctrine to strike down rules limiting the use of losses and write-downs by parent companies based on the residence of subsidiaries,¹¹¹ thin capitalization rules that applied to interest paid to foreign shareholders or directors,¹¹² exit taxes,¹¹³ and rules that limited exemptions on immovable property tax based on residence or treaty status.¹¹⁴ The Court has permitted group tax relief rules limiting use of losses only if the limitations allow the use of foreign subsidiaries' losses if those foreign subsidiaries have exhausted all other options.¹¹⁵ The only rule that the Court has allowed to stand unconditionally is the Finnish anti-avoidance rule limiting deductible intragroup financial transfers based on residence.¹¹⁶

Despite the many ambiguities surrounding the doctrine, internal inconsistency is not necessarily a death knell for a doctrine still in its early stages. Courts in many jurisdictions first establish flexible judicial standards to address new legal issues that are so complex as to require input from other governmental entities,¹¹⁷ and anti-avoidance provisions are sufficiently complex to require a flexible approach by the European Court of Justice. Furthermore, given the difficulty of reconciling Member States' reserved sovereignty over direct taxation with the ECJ's jurisdiction over *all* free movement cases, including those involving direct taxation, an inconsistent doctrine may be the best possible response. As will be shown in Parts III.B and III.C below, however, the doctrine raises significant con-

111. See Case C-264/96, *Imperial Chem. Indus. plc (ICI) v. Kenneth Hall Colmer (HM Inspector of Taxes)*, 1998 E.C.R. I-4695; Case C-347/04, *Rewe Zentralfinanz eG v. Finanzamt Köln-Mitte*, 2007 E.C.R. I-02647.

112. Case C-105/07, *Lammers & Van Cleeff NV v. Belgische Staat*, 2008 E.C.R. I-00173; Case C-324/00, *Lankhorst-Hohorst GmbH v. Finanzamt Steinfurt*, 2002 E.C.R. I-11779.

113. Case C-9/02, *Hughes de Lasteyrie du Saillant v. Ministère de l'Économie, des Finances et de l'Industrie*, 2004 E.C.R. I-2409.

114. Case C-451/05, *Européenne et Luxembourgeoise d'investissements SA (ELISA) v. Directeur général des impôts and Ministère public*, 2007 E.C.R. I-08251.

115. Case C-446/03, *Marks & Spencer plc v. David Halsey (HM Inspector of Taxes)*, 2005 E.C.R. I-10837.

116. Case C-231/05, *Oy AA* 2007 E.C.R. I-06373.

117. The treatment by Delaware courts of takeover law in the 1980s is an example of this approach. See, e.g., Mark J. Roe, *Delaware's Competition*, 117 HARV. L. REV. 588, 626-27 (2003) (referring to the fact that the "mid-1980s court decisions zigzagged").

cerns for Member States and the EU legal order as well, and these concerns highlight the need for the involvement of the other institutions of the EU and the Member States in reaching a solution.

B. Member States and the Wholly Artificial Arrangements Doctrine

The uncertainty and ambiguity created by the wholly artificial arrangements doctrine do not only affect taxpayers. Since the wholly artificial arrangements doctrine sets the limit for anti-avoidance rules in all Member States, the doctrine also affects Member State courts and legislatures. Domestic courts are forced to interpret domestic anti-avoidance rules in the context of the ECJ's doctrine, and Member State legislatures must amend or repeal anti-avoidance rules they otherwise would have retained.

On the judicial front, the effect of the confusion surrounding the wholly artificial arrangements doctrine can be seen most clearly in the effort of courts other than the European Court of Justice to grapple with the precedent set by the Court. On July 27, 2007, the United Kingdom Commissioners for the Special Purposes of the Income Tax Act (Special Commissioners) held in *Vodafone 2 v. Revenue and Customs Commissioners*¹¹⁸ that the CFC legislation challenged in *Cadbury Schweppes* could be read as compatible with the wholly artificial arrangements doctrine. *Vodafone 2*, which was filed before the ECJ's decision in *Cadbury Schweppes*, addressed the United Kingdom's CFC rules,¹¹⁹ and the Special Commissioners had referred the case to the ECJ for a preliminary ruling, also prior to *Cadbury Schweppes*.¹²⁰ In their ruling of July 2007, the Special

118. *Vodafone 2 v. Revenue and Customs Comm'rs*, 2008 EWHC (Ch) [1569] [hereinafter *Vodafone 2 I*].

119. Note that these were the same rules as were challenged in *Cadbury Schweppes*. Although the United Kingdom had amended these rules by the time of the *Vodafone 2 I* ruling, see *infra* notes 137–40 and accompanying text, the pre-reform rules were the ones at issue in this case.

120. *Vodafone 2 I*, *supra* note 118, ¶ 1. Cases regarding direct taxation have arrived before the ECJ in one of two ways: pursuant to Article 226 or Article 234. Article 226 provides for the Commission to bring an action against a Member State that it considers to have failed to fulfill an obligation under the Treaty. EC Treaty, *supra* note 8, art. 226. Before the Commission may bring such an action, the Commission must notify the Member State and issue a reasoned opinion on the matter. *Joined Cases C-397/98 and C-410/98, Metallgesellschaft Ltd. v. Comm'rs of Inland Revenue and HM Attorney General*, 2001 E.C.R. I-1727, ¶ 38. Article 234 provides for national courts to refer cases to the ECJ for preliminary rulings. EC Treaty, *supra* note 8, art. 234. Under Article 234, a national court

Commissioners considered the effect of *Cadbury Schweppes* on the *Vodafone 2* reference for a preliminary ruling. The two Special Commissioners agreed on the following definition of wholly artificial arrangements:

‘Wholly artificial arrangements’ as that term is used in the judgment in *Cadbury Schweppes* are such arrangements intended solely to escape tax charged by the Member State where the parent company is resident (in this case, the UK) and, in addition to the subjective element consisting in the intention to obtain a tax advantage, exhibiting objective circumstances showing that, despite formal observance of the conditions laid down by Community law, the objective pursued by freedom of establishment . . . has not been achieved and the arrangements do not reflect economic reality.¹²¹

Their agreement ended there, however, with one Special Commissioner, Mr. Walters, arguing that the motive test could be read as restricted to wholly artificial arrangements¹²² and the other Commissioner, Mr. Wallace, arguing that it could not.¹²³ The Special

can only refer a case to the ECJ if the interpretation of EU law is necessary for a decision in the case. *Id.* The ECJ has ruled, however, that a national court may refer a hypothetical situation for a preliminary ruling if an action is pending before the Court and the ECJ has all the information necessary for a preliminary ruling. Case C-436/00, Opinion of Advocate General Mischo, X and Y v. Riksskatteverket, 2002 E.C.R. I-10829, ¶ 17–19. Any national court may refer a case for a preliminary ruling if it meets the requirements of Article 234, but a court of last resort must refer such a case. EC Treaty, *supra* note 8, art. 234. The vast majority of ECJ direct tax cases have arrived at the Court under Article 234 rather than Article 226. Kingston, *supra* note 36, at 1322 n.4 (stating that 41 of the 49 ECJ cases addressing direct taxation and freedom of movement between April 2001 and April 2007 were Article 226 proceedings).

121. *Vodafone 2 I*, *supra* note 118, ¶ 15. Note that both Commissioners agree with this interpretation. *See id.* ¶ 80 (stating that Mr. Wallace “is in agreement with the Decision up to paragraph 67, but he parts company at that point”).

122. *Id.* ¶¶ 69–72.

123. *Id.* ¶¶ 73–80. The Special Commissioners summarized their disagreement as follows:

Mr. Walters considers that a restriction in the application of the motive test as defined in the CFC legislation to its application only to wholly artificial arrangements can be “read down” into s.748(3) ICTA as a matter of conforming interpretation, and the result would not be inconsistent with the scheme or ‘grain’ of the motive test as so defined to be to serve as part of the legislative mechanism in place to ensure that the CFC legislation is not applicable in situations which are not abusive (or, put positively, to ensure that the CFC legislation is only applicable in abusive situations). Mr. Wallace, on the other hand,

Commission thus only reached its interpretation based on a procedural rule that gave the former Commissioner a deciding vote.¹²⁴

Vodafone 2 was appealed to the High Court of Justice (Chancery Division), which overturned the Special Commissioners on July 4, 2008.¹²⁵ The High Court found that it is “impossible to construe [the CFC provision] so as to make it conform with the right of freedom of establishment under Article 43”¹²⁶ and dismissed HMRC’s inquiry into Vodafone’s tax return.¹²⁷ These opposite holdings, as well as the lower court’s internal disagreements, suggest that the definition of a wholly artificial arrangement is opaque even to the courts that the ECJ expects to apply the doctrine.

On the legislative front, along with striking down provisions such as those in *ICI*, *Lankhorst-Hohorst*, *Lasteyrie*, *Rewe*, *ELISA*, and *Lammers*, the doctrine has the effect of leading Member States to amend or eliminate domestic provisions that were previously used to police tax avoidance. Although application of the doctrine does not always lead to the immediate defeat of an anti-avoidance provision, the mere existence of the doctrine has led Member States to change their approach to policing anti-avoidance measures. Just as anti-avoidance doctrines are often understood to affect the tax planning of taxpayers aiming to escape audit or challenge, the wholly artificial arrangements doctrine has led Member States to alter their anti-avoidance rules even before they could be challenged under the developing doctrine.

On December 10, 2007, the European Commission issued a communication in response to *Cadbury Schweppes* and *Thin Cap*

takes the view that, although a provision restricting the CFC legislation to wholly artificial arrangements would not be inconsistent with the basic purpose of the CFC legislation, the European Court in *Cadbury Schweppes* did not envisage reading into the motive test a restriction which is wholly absent from that test as defined in the legislation.

Id. ¶¶ 83–84.

124. *Id.* ¶ 108 (referring to reg. 18(2) of the Special Commissioners (Jurisdiction and Procedure) Regulations, 1994, SI 1994 No. 1811). Reg. 18(2) provides, “Where proceedings are before a Tribunal which comprises two Special Commissioners, in the event of an equality of votes, the Special Commissioner presiding at the hearing shall be entitled to a second or casting vote.” Reg. 18(2), SI 1994 No. 1811.

125. *Vodafone 2 v. Revenue & Customs Comm’rs*, [2008] EWHC (Ch) 1569 [hereinafter *Vodafone 2 II*].

126. *Id.* ¶ 39.

127. *Id.* ¶ 90. (“In my judgment the CFC legislation, which depends on section 747 and section 748 for its effectiveness, must be disapplied so that, pending such amending legislation or executive action, no charge can be imposed on a company such as Vodafone under the CFC legislation. It follows that HMRC’s enquiry into Vodafone’s tax return for the accounting period has no legitimate purpose and should be closed.”).

GLO.¹²⁸ In this document, the Commission stated that, in light of the ECJ's recent decisions, "there is an urgent need (i) to strike a proper balance between the public interest of combating abuse and the need to avoid disproportionate restrictions on cross-border activity within the EU; and (ii) for better coordination of the application of anti-abuse measures in relation to third countries in order to protect [Member States]' tax bases."¹²⁹ This communication acknowledged that the wholly artificial arrangements doctrine, as developed in the Court's decisions, would have "implications for [Member States]' tax systems"¹³⁰ and encouraged Member States to undertake a general review of their anti-avoidance rules and to work with the Commission to "promote a better understanding" of these implications.¹³¹

In response to the ECJ's new doctrine and the Commission's encouragement, many Member States have changed domestic direct tax measures that were otherwise not under review. In other words, the creation of the doctrine has forced Member States to rewrite direct tax provisions for reasons other than revenue demands or changes in fiscal policy. In Italy, the legislature responded to *Lankhorst-Hohorst* by limiting Italy's thin capitalization rules, enacted in 2004, to only apply domestically.¹³² After *Cadbury Schweppes*, Denmark announced plans to amend its CFC rules,¹³³ Sweden changed its CFC rules,¹³⁴ and Germany limited the application of its CFC rules.¹³⁵

128. European Commission, *The Application of Anti-Abuse Measures in the Area of Direct Taxation—Within the EU and in Relation to Third Countries*, COM (2007) 785 final (Dec. 10, 2007) [hereinafter COM(2007)]; (stating that *Cadbury Schweppes* and *Thin Cap GLO* "were largely responsible for the commission's decision to release the December 10 communication").

129. *Id.* at 2.

130. *Id.* at 9.

131. *Id.*

132. See Marco, *supra* note 29.

133. Jens Wittendorff, *Denmark to Change CFC Rules*, WORLDWIDE TAX DAILY, Oct. 4, 2006, Doc 2006-20662, available at LEXIS, 2006 WTD 192-2 (stating that the existing Danish CFC rules were "not confined to wholly artificial arrangements created to escape the tax normally due on profits generated by activities carried out in Denmark").

134. Peter Sundgren, *Swedish CFC Taxation and the 'Business Purpose' Concept*, 50 TAX NOTES INT'L 133 (2008). Sundgren argues that this requirement "corresponds broadly . . . with the so-called business purpose doctrine developed mainly in common-law countries." *Id.* Under the new rules, a CFC must have its own physical premises, equipment, personnel and "day-to-day operations [must] be carried out independently . . . without the influence or involvement of staff from the CFC's parent company or any other company within the business group." *Id.* In passing these rules, legislators debated whether the requirement of a "real establishment engaged in genuine business operations" conformed to the wholly artificial arrangements doctrine as defined in *Cadbury Schweppes*. *Id.* Although the

As the Member State whose anti-avoidance legislation was called into question by the ECJ in *Cadbury Schweppes*, the United Kingdom was the most immediately responsive Member State to the Court's anti-avoidance jurisprudence. The Court in *Cadbury Schweppes* did not determine whether the motive test in the United Kingdom's CFC rules was sufficient to limit the rules' application to wholly artificial arrangements and instead left that determination to United Kingdom domestic courts. While commentators asserted that the motive test defined tax avoidance more broadly than would the wholly artificial arrangements doctrine,¹³⁶ the difference between the UK's existing CFC regime and EU law remained in question while HM Revenue and Customs (HMRC) set about reforming the existing legislation before the decision of the High Court of Justice determined the legitimacy of the previous CFC rules.¹³⁷ In June 2007, HMRC issued a discussion document that addressed reform of the CFC rules, among other items.¹³⁸ In order to escape a tax penalty

Swedish government argued that the new rules accurately reflect the requirements of EU law after *Cadbury Schweppes*, at least one commentator has argued that the Swedish law defines tax avoidance much more broadly than does the wholly artificial arrangements doctrine. *Id.*

135. Jan Becker et al., *Impact of ECJ's Cadbury Schweppes Decision on German Tax Planning*, 45 TAX NOTES INT'L 879 (2007). On January 8, 2007, the German Ministry of Finance issued a binding decree pursuant to which Germany's CFC rules will *not* apply to a subsidiary in the European Economic Area (EEA) that: (i) "carri[es] out business activities in the country of the subsidiary's residence on a regular basis," (ii) employs "sufficient managing and supporting staff" that is "appropriately skilled" and can "perform the subsidiary's tasks independently," (iii) earns its income "through activities carried out by the company itself", and (iv), in cases in which its revenue is "predominantly from related-party transactions," provides a service that generates value for the related person and has capital funding appropriate to the value being added. Although Germany intended this amendment to comply with the wholly artificial arrangements doctrine, commentators have suggested that the amended CFC rules still define tax avoidance too broadly. *See id.* ("It is doubtful that the decree's business activity test is in full compliance with ECJ jurisprudence"); Whitehead, *supra* note 76, at 181 (arguing that the amended rules' focus on the existence of workers is broader than the ECJ's requirement of fictitious arrangements).

Although the anti-avoidance rules of all Member States are subject to the wholly artificial arrangements doctrine, not all Member States changed their rules in response to the ECJ's jurisprudence. This may be due partially to the fact that some Member States did not have similar rules to those challenged before the ECJ, *see generally* Organisation for Economic Co-operation and Development, *Harmful Tax Competition: An Emerging Global Issue* (1998) (advocating the adoption of anti-avoidance rules for those OECD member state countries that did not have them), and partially to the fact that some Member States are less compliant. *See infra* note 202 and accompanying text.

136. *See, e.g.*, David Taylor & Laurent Sykes, *Controlled Foreign Companies and Foreign Profits*, 5 BRIT. TAX REV. 609, 612 (2007).

137. *See supra* notes 118–27 and accompanying text.

138. West, *supra* note 25 at 1170 (stating that "the consultation document is widely

under the proposed new rules, a CFC must have a “business establishment” in an EEA territory, as well as individuals who “work for” the CFC in the territory during the period in question and “net economic value” from activities arising from labor, not capital.¹³⁹ This reform has been critiqued as an insufficient response to *Cadbury Schweppes* that still defines tax avoidance more broadly than does the wholly artificial arrangements doctrine.¹⁴⁰

Even those Member States that have not voluntarily considered their own anti-avoidance strategies have felt the effects of the wholly artificial arrangements doctrine on their direct tax authority. In February 2008, the Commission sent Spain a reasoned opinion requesting that it amend its anti-abuse rules.¹⁴¹ Under Article 226, this reasoned opinion is the first step in a process that could culminate with the Commission referring the case to the ECJ if Spain does not make the requested amendments.¹⁴² Together, these responses highlight the very real impact that the wholly artificial arrangements doctrine is having on Member States’ ability to exercise their chosen level of discretion in policing tax avoidance to the extent. As will be discussed in Part III.C, these legislative responses raise concerns for both Member State sovereignty and the future of EU law.

viewed as the government’s response to *Cadbury Schweppes*”). *See also id.* at 1171 n.81 (stating that “[i]t is understood that HMRC coordinated closely with the IRS in drafting the consultation document”).

139. Taylor & Sykes, *supra* note 136, at 620–24. Taylor and Sykes distinguish the requirements for section 751A to apply from those laid out by the ECJ in *Cadbury Schweppes*. *See id.* at 620.

140. *See id.* at 614 (stating that the UK government’s “response to the *Cadbury Schweppes* judgment reflects a denial that there is . . . a gap” between passive mobile income and income from wholly artificial arrangements). *See also id.* at 628 (arguing that “section 751A is an inadequate response to *Cadbury Schweppes*”); Peter Nias & James Ross, *United Kingdom Makes Minimal Changes to CFC Rules*, *WORLDWIDE TAX DAILY*, Dec. 22, 2006, Doc 2006-25439, available at LEXIS, 2006 WTD 246-2 (suggesting that the UK government’s response to both *Cadbury Schweppes* and *Marks & Spencer* has been to see the decisions as—incorrectly—just requiring “a few minor tweaks required to remove any ambiguity”).

141. Press Release, European Union, Corporate Taxation: Commission Requests Spain to Amend Discriminatory Anti-Abuse Rules (Feb. 28, 2008). The anti-abuse rules in question include tax treatment of dividends distributed by companies established in certain Member States or territories of the EU, CFC rules and provision regarding non-deductibility of depreciation.

142. *See id.*

C. *The EU Legal Order and the Wholly Artificial Arrangements Doctrine*

As shown by their different approaches to amending domestic anti-avoidance rules, Member States themselves are not certain of the effect of the wholly artificial arrangements doctrine. To the extent that there is any Member State agreement on the doctrine, however, it is that the doctrine is excessively restrictive. During the hearing in *Rewe*, the German government stated that it believed the “specific objective of the counteraction of purely artificial arrangements to be unduly restrictive” and requested that the case law of the Court in this area be relaxed.¹⁴³ The government argued that Member States must have the ability to “enact general measures of principle, designed to counteract tax avoidance and to adopt abstract and general regulations targeted at specific avoidance schemes.”¹⁴⁴ The Court acknowledged the government’s concerns but then moved directly to its application of the wholly artificial arrangements doctrine nonetheless. Although the scope of a wholly artificial arrangement is still undefined, *Rewe* shows that Member States fear that the definition is far narrower than the unacceptable tax avoidance that their legislation previously punished.

From the point of view of Member States, the wholly artificial arrangements doctrine is problematic not just because of its internal inconsistencies but also because of the limitations it poses to their sovereignty and their ability to operate an effective tax system, itself at the core of nationhood. As discussed at the start of Part II, the Member States of the EU face many challenges in the form of tax avoidance. Along with the many domestic tax avoidance schemes that all nations face, Member States, particularly the higher-tax jurisdictions in the EU, face concerns about deferral and allocation. Member States have responded to these concerns by following the lead of the United States and the advice of the OECD and passing a number of anti-avoidance rules, including provisions applying to CFCs, thin capitalization, and group relief. In keeping with an international trend, Member States have been moving in the direction of strengthening their anti-avoidance regimes.¹⁴⁵ The Court’s develop-

143. Case C-347/04, *Rewe Zentralfinanz eG v. Finanzamt Köln-Mitte*, 2007 E.C.R. I-02647 ¶ 50, available at <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:62004J0347:EN:HTML>.

144. *Id.*

145. See generally West, *supra* note 25 (discussing efforts by Germany, France, the United Kingdom, Canada and the United States to prevent tax avoidance). One example is Germany’s codification of abuse of law in 2008, in which Germany prohibits “inappropriate

ment of the wholly artificial arrangements doctrine, however, has thwarted these Member State efforts to police tax avoidance. After the rulings discussed in Part II, Member States can no longer maintain anti-avoidance rules similar to those in *ICI*, *Lankhorst-Hohorst*, *Lasteyrie due Saillant*, *Rewe*, *ELISA*, and *Lammers*, nor can they maintain anti-avoidance rules similar to those in *Cadbury Schweppes*, *Thin Cap GLO*, or *CFC Test Claimants* if those rules apply to transactions other than wholly artificial arrangements. Member States are constrained in their ability to pass CFC and thin capitalization rules, both of which are common in jurisdictions outside the EU. They are prevented from passing limitations on group losses that differentiate based on the residence of the majority of subsidiaries,¹⁴⁶ thin capitalization rules that apply to all non-resident parent corporations,¹⁴⁷ departure taxes that apply to all residents moving out of the jurisdiction,¹⁴⁸ and limitations on property tax exemptions that apply only to residents of the jurisdiction or jurisdictions that had signed a relevant tax treaty.¹⁴⁹ While some of these impermissible rules, such as the property tax exemption limitation in *ELISA*, may be explicitly discriminatory, others, such as thin capitalization rules and CFC rules, are common anti-avoidance rules in other jurisdictions that are generally considered not to be discriminatory under the nondiscrimination concept applied by the Organisation for Economic Cooperation and Development.¹⁵⁰

legal arrangements." *Id.* at 1171 (stating that the German codification "would appear to be similar to the disjunctive version of the economic substance test as applied in the United States").

146. See Case C-264/96, *Imperial Chem. Indus. v. Kenneth Hall Colmer* (HM Inspector of Taxes), 1998 E.C.R. I-4695; Case C-347/04, *Rewe Zentralfinanz eG v Finanzamt Köln-Mitte*, 2007 E.C.R. I-02647.

147. See Case C-324/00, *Lankhorst-Hohorst GmbH v. Finanzamt Steinfurt*, 2002 E.C.R. I-11779; Case C-105/07, *Lammers & Van Cleeff NV v. Belgisch Staat*, 2008 ECR I-00173.

148. See Case C-9/02, *Hughes de Lasteyrie du Saillant v. Ministère de l'Economie, des Finances et de l'Industrie*, 2004 E.C.R. I-2409.

149. See Case C-451/05, *Européenne et Luxembourgeoise d'investissements SA (ELISA) v. Directeur général des impôts and Ministère public*, 2007 E.C.R. I-08251.

150. Although the norms created by the OECD do not necessarily inform the institutions of the EU, its role as an international organization with both tax expertise and overlapping membership with the EU means that many EU Member States look to the OECD for fiscal guidance.

Readers should note that the wholly artificial arrangements doctrine *only* limits anti-avoidance rules that apply across borders. Member States are still free to pass anti-avoidance rules that apply only to their citizens within their borders and that do not in any way affect freedom of movement. Such rules would not, however, have any effect on international tax avoidance. Given the growing problem of cross-jurisdictional tax avoidance, see Organisation for Economic Co-operation and Development, *Harmful Tax Competition*:

The creation of the wholly artificial arrangements doctrine thus directly contradicts the unanimity requirement of Article 94. Despite the fact that no EU institution has the authority to legislate in the area of direct taxation without the support of all twenty-seven Member States, the European Court of Justice is using this new doctrine to curtail Member State authority over just this area. As the need for anti-avoidance legislation increases, Member States are being prevented from passing such legislation in the form that they choose due to both the actual application of the wholly artificial arrangements doctrine and the specter of litigation leading to such application. The wholly artificial arrangements doctrine effectively creates a vacuum in which Member States are not permitted to pass certain anti-avoidance provisions, but no EU institution yet has the authority to pass any EU-wide anti-avoidance doctrine. Due to this judicially created principle of limitation, the Member States of the EU are thus more open to tax avoidance than they would be as completely independent nations.

Furthermore, the wholly artificial arrangements doctrine allows Member States to fully police tax avoidance outside the EU, but not within the EU. Further, because freedom of movement only applies within the EU, the wholly artificial arrangements doctrine only limits the application of anti-avoidance rules within the borders of the EU.¹⁵¹ In other words, while a Member State is free to punitively tax the owners of a CFC in, say, the United States, the same Member State cannot impose the same punitive tax on an identical CFC in Ireland, despite the latter's recognized use as a tax haven.¹⁵²

These restrictions on Member State sovereignty are not unexpected. As many commentators have reflected, complete Member State sovereignty over direct taxation and complete integration cannot coexist.¹⁵³ Although the impossibility of reconciling these two

An Emerging Global Issue 25–36 (1998). Member States in recent decades have been increasing—in both strength and number—just those rules that implicate the wholly artificial arrangements doctrine.

151. See Case C-264/96, *Imperial Chem. Indus. v. Kenneth Hall Colmer* (HM Inspector of Taxes), 1998 E.C.R. I-4695. See also Pasquale Pistone, *Taxation of Cross-Border Dividends in Europe: Building Up Worldwide Tax Consistency*, 62 *TAX L. REV.* 67, 70 (2008).

152. See Press Release, The White House, *Leveling the Playing Field: Curbing Tax Havens and Removing Tax Incentives For Shifting Jobs Overseas* (May 4, 2009), available at http://www.whitehouse.gov/the_press_office.

153. See, e.g., Joann Martens Weiner, *Practical Aspects of Implementing Formulary Apportionment in the European Union*, 8 *FLA. TAX REV.* 629, 634-35 (2007) (“Broadly speaking, the ECJ has such a strong influence on EU company tax rules because it takes a different view of company tax policy than do the individual Member States. The ECJ’s goal

goals is often acknowledged, the wholly artificial arrangements doctrine highlights this impossibility for Member States. If Member States can no longer police tax avoidance—which poses a major threat to raising revenue—they no longer have complete sovereignty over direct taxation. The continued application of this doctrine will thus represent the partial victory of integration over direct tax sovereignty, without the benefit of a more integrated approach to fighting tax avoidance.

IV. TOWARD A CLEARER APPROACH TO POLICING TAX AVOIDANCE

The wholly artificial arrangements doctrine has created an unsustainable situation. The EU currently faces an internal vacuum in which neither Member State sovereignty over taxation nor full integration is achieved. Member State sovereignty is threatened by a doctrine that strikes down domestic anti-avoidance rules. Full integration is threatened by Member State unwillingness to assent to EU-wide anti-avoidance rules. Within this vacuum are EU taxpayers, left in a world of greater tax avoidance, lower tax revenues and doctrinal uncertainty. Ultimately, the EU and its constituents must decide between retained sovereignty or greater integration in the area of tax avoidance. Part IV.A discusses the two routes that the EU legal order can follow: (i) jurisdiction-stripping, which would limit the jurisdiction of the ECJ and favor sovereignty over integration, or (ii) harmonization of anti-avoidance rules, which would favor integration over sovereignty.

Because of the political impossibility of choosing either of these paths in the near future, this Article also discusses medium- and short-term solutions that various EU entities could adopt to ameliorate some of the concerns raised in Part III. Part IV.B discusses a range of medium-term responses, none of which completely addresses the vacuum created by the wholly artificial arrangements doctrine, but which still could prove more politically palatable than the long-term solutions discussed in Part IV.A. Finally, Part IV.C advocates the ECJ's adoption of a more flexible approach to anti-

is to create a seamless 'internal union' where companies are able to invest in any Member States within the EU without facing discriminatory taxation when they do so. The Member States, however, often enact policies that protect their national tax bases, sometimes in a discriminatory fashion. As O'Shea has commented, 'what is "tax avoidance" from one Member State's perspective is simply an exercise of the freedoms from another state's point of view.'").

avoidance cases as a short-term solution to the problems raised by the wholly artificial arrangements doctrine.

Part IV takes a fairly pessimistic view of the likelihood of the long-term and medium-term proposals coming to fruition in the near future because of the institutional constraints inherent in the EC Treaty as it now stands. Since the EC Treaty requires the unanimous consent of all twenty-seven Member States for any measure that affects direct taxation or strips the ECJ of jurisdiction, most of the solutions proposed in this Part would require all Member States—regardless of their very different fiscal policies—to agree to any one course of action. The fact that different Member States are currently moving in different directions—with some supporting integration,¹⁵⁴ others supporting harmonization,¹⁵⁵ and many in between these two extremes—suggests that reaching unanimity on an issue as contentious and politically charged as direct taxation is unlikely in the near future. Given that the history of the EU is in many ways a history of the Member States and institutions reaching political decisions despite commentator predictions,¹⁵⁶ however, this Part considers several solutions that may prove to overcome the institutional hurdles that seem likely to block almost all efforts to strike a balance between sovereignty and integration in the foreseeable future.

A. *Long-Term Responses: Sovereignty or Integration?*

Ultimately, the EU legal order must move in one direction: toward greater sovereignty or toward greater integration. This is a political decision that the EU as a whole needs to make.¹⁵⁷ If this choice is not made, Member States could build on the core weakness of the EU legal order and unilaterally nullify ECJ anti-avoidance rul-

154. See *infra* note 170 and accompanying text.

155. See *infra* note 177 and accompanying text.

156. Compare, e.g., Martin Feldstein, *The Political Economy of the European Economic and Monetary Union: Political Sources of an Economic Liability* (Nat'l Bureau of Econ. Research, Working Paper No. 6150, 1997) with, e.g., Press Release, European Central Bank, Tenth Anniversary of the ECB: Publication of a Special Edition of the ECB's Monthly Bulletin (May 29, 2008).

157. This Article consciously does not decide between these two ultimate goals because such a decision is a purely political choice to be made by Member State governments. Although Member States agreed to a certain degree of integration when they joined the EU, they also attempted to limit this integration by including Article 94 and similar provisions in the EC Treaty. This Article thus does not assume that integration, rather than sovereignty, is the logical next step. Cf. van Thiel 2008, *supra* note 7, at 186 (referring to the "agreed and, therefore, self-imposed, constitutional margins" set out in the EC Treaty).

ings by refusing both to enforce them domestically and to refer any future anti-avoidance cases for preliminary rulings. Although domestic courts have shown themselves willing to enforce ECJ rulings,¹⁵⁸ even when these rulings push Member States toward greater integration at the expense of sovereignty, the effectiveness of EU law ultimately depends on the willingness of domestic courts to enforce it.¹⁵⁹ If one or more Member States determine that the wholly artificial arrangements doctrine and the limits it imposes on Member State sovereignty are unbearable, those Member States can simply refuse to enforce relevant ECJ rulings. No matter how many cases are brought against those Member States, whether by other Member States or the Commission, enforcement ultimately rests in the hands of domestic courts.¹⁶⁰

Domestic courts are also responsible for determining when and if to refer questions for preliminary rulings.¹⁶¹ Already, the unequal number of preliminary rulings from different jurisdictions suggests that certain Member States are less active in turning to the ECJ

158. Alexander Somek, *Inexplicable Law: Legality's Adventure in Europe*, 15 *TRANSNAT'L L. & CONTEMP. PROBS.* 627, 632 (2006) (stating that "national courts have connived in undermining national sovereignty through 'dis-applying' their own national laws").

159. See Matthew T. King, Comment, *Towards a Practical Convergence: The Dynamic Uses of Judicial Advice in United States Federal Courts and the Court of Justice of the European Communities*, 63 *U. PITT. L. REV.* 703, 721 (2002) ("After issuing a Preliminary Ruling, the ECJ has little to rely on to ensure that the opinion will be enforced as such."); *Id.* at 721–22 (referring to J.H.H. Weiler's lack of confidence in Member States' willingness to enforce ECJ judgments); Anne-Marie Slaughter, *Sovereignty and Power in a Networked World Order*, 40 *STAN. J. INT'L L.* 283, 302 (2004) (pointing out that ECJ does not have "direct enforcement power" and that it is "up to the national courts, which retained the de facto sovereign right to implement the ECJ's decisions").

160. See Sara Dillon, *The Mirage of EC Environmental Federalism in a Reluctant Member State Jurisdiction*, 8 *N.Y.U. ENVTL. L.J.* 1, 70–71 (1999) (referring to "the cumbersome process of bringing legal actions against the Member States [under Art. 226], only to have the Court of Justice make ringing pronouncements of no ultimate utility to plaintiffs in their national forums"). Note that some Member State courts may be implicitly following this course of action already. Spain, for example, has not yet referred an anti-avoidance case to the ECJ, see *infra* note 203, nor has it reformed its anti-avoidance rules in accordance with the wholly artificial arrangements doctrine, see *supra* note 141.

161. See *id.* at 8–9 ("It is not sufficiently appreciated, especially outside Europe, that the enforcement of Community law depends upon the willingness of the national courts to accept the role of European courts. . . . If the level of willingness to refer European law questions under Article 234 (ex 177) is in fact very uneven across the various Member States jurisdictions of Europe, this cannot be seen as equitable."); Somek, *supra* note 158, at 631–32 (stating that "the success of European integration, from a legal point of view, has depended vitally on the cooperation between the ECJ and national courts").

for guidance on direct taxation matters.¹⁶² Member States could respond to the constraints created by the wholly artificial arrangements doctrine by refusing to send any anti-avoidance preliminary references to the ECJ. Such a refusal would stop the development of the doctrine; paired with refusal to enforce any anti-avoidance rulings, this effective nullification would make the wholly artificial arrangements doctrine entirely toothless.¹⁶³

The clear downside to this unilateral nullification is that it would ultimately undermine the entire legal order of the EU. The EU relies on enforcement of EU law by all Member State courts. Were certain courts to refuse to enforce ECJ rulings in certain areas, the validity and enforceability of all EU law would be put in question and opened to domestic public pressure. Member State nullification is thus a worst-case scenario,¹⁶⁴ but it is instructive to include it here to emphasize that, if Member States and EU institutions do not otherwise respond to the ECJ's development of the wholly artificial arrangements doctrine, nullification could be the ultimate outcome as Member States strive to save their sovereignty over direct taxation from the encroachment of the ECJ. To avoid this worst-case scenario, the choice of outcome is essentially a choice between two long-term goals: (i) jurisdiction-stripping or (ii) harmonization of anti-avoidance rules.

These two long-term goals essentially take two different paths to achieve the same goal, which is the elimination of the asymmetry that currently exists between judicial and legislative authority over direct taxation in the EU. In the area of direct taxation, this asymmetry exists because the legislative bodies lack authority to regulate without the unanimous consent of Member States, but the judiciary, in the form of the ECJ, has jurisdiction over direct tax cases that raise freedom of movement questions. In contrast, other areas of EU law, as well as taxation in other countries, do not exhibit such asymmetry. In the EU, for example, many subject areas require unanimous consent, but these areas either are not as closely tied to sovereignty, thus making it easier for Member States to vote in favor of legislative measures,¹⁶⁵ or do not fall under the ECJ's jurisdiction.¹⁶⁶ In the

162. See *infra* notes 202–03 and accompanying text.

163. Although the Commission could continue to bring cases before the ECJ, complete Member State refusal to enforce anti-avoidance rulings would undermine the effectiveness of such an approach.

164. Although another potential response could be withdrawal from the EU, this Article sees such a response as unlikely. For more on the right of Member States to withdraw unilaterally, see Conte, *supra* note 9, at 384–85.

165. See *supra* notes 27–29 and accompanying text.

166. See *supra* note 9.

United States, subnational tax measures meant to curb tax avoidance may be struck down by the United States Supreme Court, but the asymmetry exhibited here is not as pressing an issue because the United States Congress has the authority to pass harmonizing measures.¹⁶⁷ The judicial activism of the European Court of Justice in the direct tax arena¹⁶⁸ is thus different from other comparable exercises of judicial power because the legislature has no ability to respond without the consent of all Member States.¹⁶⁹ Any ultimate solution must thus resolve this asymmetry, either by limiting the ECJ's jurisdiction to match the authority of other EU institutions or by expanding the authority of other EU institutions to match the jurisdiction of the ECJ.

1. Restriction of Jurisdiction

The one response that would address the fundamental issue of the ECJ's encroachment on Member State sovereignty over direct taxation would be to restrict the Court's jurisdiction by preventing it from considering anti-avoidance cases—or direct tax cases entirely. Although drastic, this solution was considered during negotiations over the proposed Reform Treaty.¹⁷⁰ With limited jurisdiction, the ECJ would not have the opportunity to develop or apply the wholly artificial arrangements doctrine, and Member States would be free to retain anti-avoidance rules that violated freedom of movement.

In exchange for retained sovereignty over direct taxation, however, the Member States would create a roadblock to greater in-

167. See Brian Galle, *Designing Interstate Institutions: The Example of the Streamlined Sales and Use Tax Agreement ("SSUTA")*, 40 U.C. DAVIS L. REV. 1381, 1387 (2007) (stating, in the context of a case limiting states' abilities to prevent avoidance of sales tax due to Dormant Commerce Clause concerns, that "[t]he [Supreme] Court's interpretation of the Dormant Commerce Clause, however, can be superseded by Congress").

168. This reference to "judicial activism" is not meant to be politically charged. While some commentators have criticized the ECJ's foray into direct tax cases, others have seen the Court's exercise of jurisdiction as proper. Compare Peter J. Wattel, *Judicial Restraint and Three Trends in the ECJ's Direct Tax Case Law*, 62 TAX L. REV. 205, 207 (2008) (stating that "the court was overplaying its hand (its competence and its possibilities) in its activist years") with van Thiel 2008, *supra* note 7, at 183 ("The criticism in academic and political discussions that the ECJ would go beyond its constitutional role, is without substance. It often refers to 'judicial activism' in a negative way.").

169. Cf. *Quill Corp. v. North Dakota*, 504 U.S. 298, 318 (1992) (stating that "Congress is now free to decide whether, when, and to what extent the States may burden interstate mail-order concerns with a duty to collect use taxes").

170. Ruth Mason, *Made in America for European Tax: The Internal Consistency Test*, 49 B.C. L. REV. 1277, 1280 (2008).

tegration and a gaping inconsistency in EU law. The ECJ currently has jurisdiction over any question regarding the interpretation of EU law,¹⁷¹ and it is this jurisdiction that has allowed the ECJ to push forward integration by invalidating Member State measures that limit the freedom of movement. One of the fundamental principles of EU law is the principle of supremacy, pursuant to which EU law is granted primacy over any contradictory domestic law.¹⁷² Were the ECJ no longer permitted to rule on questions regarding the interpretation of EU law that involved direct taxation, integration would stall and the principle of supremacy, now so fundamental to EU law, would not apply in all cases. Furthermore, carving direct taxation cases out of the Court's jurisdiction creates a clear incentive for Member States and EU institutions to claim that challenged measures that would otherwise fall under the court's jurisdiction in fact relate to direct taxation.

Logistically, restricting the court's jurisdiction would require amendment of the Treaty and would again require the unanimous support of the Member States.¹⁷³ Although such support may be more likely for a measure meant to curtail ECJ action, the unanimity requirement still means that such a drastic change is unlikely to be made in the short term, particularly since proposals for just such a restriction did not make it into the Reform Treaty. Moreover, since restricting ECJ jurisdiction would have far-reaching consequences for EU law as a whole, as well as the future of integration, this solution would only be feasible if all Member States decide to prioritize sovereignty in the area of direct taxation over integration.

2. Harmonization of Anti-Avoidance Rules

The one response that would allow for full integration of anti-avoidance rules would be complete harmonization of these rules. Such harmonization would leave the regulation of tax avoidance to

171. See EC Treaty, *supra* note 8, art. 234.

172. See Rett R. Ludwikowski, *Supreme Law or Basic Law? The Decline of the Concept of Constitutional Supremacy*, 9 CARDOZO J. INT'L & COMP. L. 253, 278-79 (2001) (outlining the history of the Court's development of the principle of supremacy, which was not initially protected in the Treaty); Case 26/62, *Van Gend & Loos v. Nederlandse Administratie der Belastingen*, 1963 E.C.R. 1; Case 6/64, *Costa v. ENEL*, 1964 E.C.R. 585; Case 106/77, *Amministrazione delle Finanze dello Stato v. Simmenthal S.p.A.*, 1978 E.C.R. 629

173. This would likely also require consultation with the Court itself, since amendment to the Statute of the Court of Justice requires unanimous consent and consultation with the ECJ. EC Treaty, *supra* note 8, art. 245.

the institutions of the EU other than the ECJ and the Member States, and the entire EU would share a uniform approach to policing tax avoidance.¹⁷⁴ In effect, Member States would cede all anti-avoidance authority to the EU, and EU institutions would set the level of permissible tax avoidance within the borders of the EU.

The idea of direct tax harmonization is not unprecedented. As early as 1962, the Neumark Committee proposed harmonizing the corporate tax systems of Member States,¹⁷⁵ and proposals for harmonizing reforms have continued since then.¹⁷⁶ In 2001, such proposals resulted in the European Commission launching its effort to reform corporate taxes by creating a Common Consolidated Corporate Tax Base (CCCTB).¹⁷⁷ The CCCTB would consolidate the tax bases of certain multinational corporations within the territorial borders of the EU and then determine apportionment among the Member States according to a multi-factor formula.¹⁷⁸ To succeed at filling the legislative vacuum created by the wholly artificial arrangements doctrine, however, harmonization of direct taxation would have to apply to the tax systems of all twenty-seven Member States and all taxpayers within those twenty-seven Member States. As currently envisioned, neither CCCTB nor other proposals are likely to have such reach, and the difficulties that the CCCTB faces illustrate the difficulties any direct tax harmonization effort is likely to confront.

First, it is unclear when the Commission will be ready to introduce the CCCTB plan. Although the Commission planned to make such an introduction by the end of 2008, the EU Tax Commissioner Lázló Kovács announced that this planned schedule would not be met, stating that, although he “remain[ed] fully committed to this project, [he] would rather present a perfectly elaborated and well justified product at the appropriate time than present an incomplete one

174. The ECJ and Member States could continue to play a role by bringing or considering cases challenging the harmonizing measures as violations of the EC Treaty, but this would be very different from the current situation, where the ECJ and Member States are effectively the only institutions policing tax avoidance.

175. Jack Mintz & Joann M. Weiner, *Some Open Negotiation Issues Involving a Common Consolidated Corporate Tax Base in the European Union*, 62 TAX L. REV. 81, 88–89 (2008).

176. *Id.* at 89.

177. *Id.* at 81.

178. For more on the specifics of CCCTB, see, for example, *id.*; Reuven Avi-Yonah & Kimberly Clausing, *More Open Issues Regarding the Consolidated Corporate Tax Base in the European Union*, 62 TAX L. REV. 119 (2008); Matthias Mors, *What Does “Game Theory” Tell Finance Ministers About Whether They Should Support a Common Consolidated Corporate Tax Base in the EU?*, 62 TAX L. REV. 125 (2008); Stephen Utz, *The European CCCTB as the Outcome of a Virtual Game*, 62 TAX L. REV. 135 (2008).

just to meet an artificial deadline.”¹⁷⁹ Second, the likelihood of CCCTB being accepted by all twenty-seven Member States in the near future is debatable. Although Professors Mintz and Weiner argue that “it is possible for the EU to reach a negotiated agreement that is satisfactory to all players” in the context of the CCCTB,¹⁸⁰ other commentators disagree.¹⁸¹ If the unanimous agreement of all twenty-seven Member States is not possible, certain Member States could use enhanced cooperation, pursuant to which a limited group of Member States would unanimously agree to CCCTB.¹⁸² Although such a development is possible, it would not provide a full solution to the problems created and highlighted by the wholly artificial arrangements doctrine. If only certain Member States have a harmonized tax base, while others maintain their individual tax systems, the potential for tax avoidance by way of deferral and allocation remains and the need for a harmonized approach to anti-avoidance rules would still exist, particularly if the Member States that refuse to adopt the CCCTB are the very ones whose tax systems are most favorable to avoidance transactions.

Moreover, even if all twenty-seven Member States agree to the CCCTB, the proposal as it is currently envisioned makes CCCTB optional.¹⁸³ Under this proposal, multinational corporations would opt in to using the consolidated tax base, meaning that corporations for which the use of this base would be disadvantageous, perhaps due to the limits it could place on beneficial avoidance transactions, could choose not to take part.¹⁸⁴ As currently envisioned, CCCTB thus does not reach the level of harmonization necessary to harmonize anti-avoidance rules across the EU and thus fill the legislative vacuum created by the wholly artificial arrangements doctrine.¹⁸⁵ Further-

179. Mintz & Weiner, *supra* note 175, at 82.

180. *Id.* at 114.

181. See Avi-Yonah & Clausing, *supra* note 178; Mors, *supra* note 178; Utz, *supra* note 178.

182. See Avi-Yonah & Clausing, *supra* note 178, at 120 (stating that “[t]he change may occur nonetheless, particularly if the decision is taken through the enhanced cooperation procedure that would allow action to proceed without the unanimous support of member country governments”).

183. See *id.* at 122.

184. See *id.* Note that many Member States have advocated a compulsory system for this very reason. See Mors, *supra* note 178, at 129 (stating that “[o]ne would a priori assume that the revenue effects of a compulsory system would be ‘more positive’ as multinational groups would not have the possibility to choose one of two tax systems, which results in a lower tax burden”).

185. Note that references to the “relatively innovative anti-avoidance measure” of the CCCTB do not change this argument. Mintz & Weiner, *supra* note 174, at 93–94. This

more, even if the proposal introduced by the Commission were compulsory and accepted unanimously by all Member States, it would apply only to corporations, so cases such as *Lasteyrie* would still fall under the wholly artificial arrangements doctrine. Any attempt at harmonizing tax rates also seems unlikely at this juncture,¹⁸⁶ so neither complete base nor rate harmonization to the extent necessary to underlie a harmonized approach to policing tax avoidance is on the horizon. Finally, even base or rate harmonization would not be sufficient to combat all tax avoidance. Jurisdictions worldwide do not police only international tax avoidance; domestic tax avoidance is itself a challenge to raising revenue and shaping fiscal policy, and the institutions and Member States of the EU would need a harmonized approach to domestic tax avoidance even in the face of a harmonized base and rates.

Harmonization could also occur in the form of de facto harmonization, pursuant to which Member States would pressure other Member States to change their approach to tax avoidance. One model for bottom-up de facto harmonization in the area of taxation is the Streamlined Sales and Use Tax Agreement (SSUTA) created by subnational states in the United States.¹⁸⁷ Although this applies to indirect taxation and the constitutional limits imposed on taxation in the United States are unquestionably different from the freedom of movement limits imposed on taxation in the EU, the SSUTA still provides a useful de facto harmonization model for comparison because it represents the possibility of partial tax agreement at the Member State level in the absence of complete legislated harmonization. After attempts by these subnational states to prevent buyers from avoiding sales tax were struck down by the United States Supreme Court as a violation of the Commerce Clause,¹⁸⁸ several states created a multilateral agreement to harmonize their sales tax systems.¹⁸⁹ Although the ability of Congress to legislate in this area highlights the lack of asymmetry between legislative and judicial bodies in the United States case, the multilateral agreement suggests

measure, known as the “switch-over clause,” is meant to prevent avoidance transactions between the EU and third countries, and thus applies “to certain income earned outside the CCCTB’s territorial scope.” *Id.* This measure does not apply to corporations that choose not to opt in to the CCCTB, nor is it clear whether it applies to countries within the EU that do not take part in enhanced cooperation.

186. See Graetz & Warren, *supra* note 4, at 1189 n.127 (stating that the Commission has opposed moving toward rate harmonization).

187. See STREAMLINED SALES AND USE TAX AGREEMENT, available at <http://streamlinedsalestax.org/agreement/htm> (hereinafter SSUTA).

188. See *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992).

189. Galle, *supra* note 163, at 1387.

one method for de facto harmonization. A further benefit of following this model is that Member State multilateral action in the area of anti-avoidance would respond to concerns about the principle of subsidiarity.¹⁹⁰ The SSUTA also provides a warning of the dangers of partial de facto harmonization, however, in that some major retail states have refused to sign on to the agreement, thereby halting complete harmonization of state taxation.¹⁹¹

In the absence of harmonization initiated by the states, de facto harmonization could also take the form of higher-tax jurisdictions coercing lower-tax jurisdictions into raising their rates or disallowing avoidance transactions within their borders, or it could take the form of a race to the bottom, with lower-tax jurisdictions pulling other Member State rates down in an effort to compete. Regardless of which form it takes, however, de facto harmonization is no more likely than harmonization at the EU level in the foreseeable future, since both require the unanimous agreement, whether implicit or explicit, of all Member States to result in effective harmonization of anti-avoidance rules. If Member States choose to prioritize integration over sovereignty, however, harmonization will be the ultimate solution.

B. Middle-Term Responses

Given the difficulties inherent in any long-term solution that requires the unanimous consent of twenty-seven Member States with very different views of fiscal policy, the institutional constraints of the EU make either long-term response unlikely in the near future. Since the Member States and institutions of the EU are unlikely to reach the political consensus necessary to achieve either of the above results, this Part considers three other approaches that the EU could take: (i) creation of an anti-avoidance agency, (ii) codification of the wholly artificial arrangements doctrine, and (iii) an increase in anti-avoidance test cases. While none of these approaches will avoid the ultimate decision between sovereignty and integration, they may be more politically palatable in the shorter term, although they are likely to face considerable opposition in the immediate future. That said, this Article considers all of them to be second-best solutions that are not as effective as the long-term solutions discussed in Part IV.A.

190. See *supra* note 33.

191. See generally Streamlined Sales Tax Governing Bd., State Info, <http://www.streamlinedsalestax.org/index.php?page=state-info> (last visited Feb 8, 2010) (not including California or New York on the list of participating states).

1. Creation of an Anti-Avoidance Agency

In a 2001 White Paper on European governance, the Commission proposed greater reliance on autonomous agencies.¹⁹² In the words of the Commission, the benefits of such agencies include “their ability to draw on highly technical, sectoral know-how, the increased visibility they give for the sectors concerned (and sometimes the public) and the cost-savings that they offer to business.”¹⁹³ One response to the creation of the wholly artificial arrangements doctrine could thus be the establishment of an anti-avoidance agency designed to review Member State anti-avoidance rules and clarify the scope of the wholly artificial arrangements doctrine in light of Member State goals. Such an agency would reduce the inconsistency of the ECJ’s application of the wholly artificial arrangements doctrine while still allowing for flexibility in determining which anti-avoidance rules are permitted under the doctrine. This solution would address the concerns with inconsistency and legitimacy addressed in Part III, while taking the decision as to the validity of an anti-avoidance rule out of the hands of the Court.

Such an agency would, however, require unanimous support and would be extremely unlikely to gain the support of Member States because it would continue to undermine Member State sovereignty over direct taxation and it could appear to be a first step in the direction of complete tax harmonization. Furthermore, in order to be effective, the agency would likely need greater competency than that envisioned by the Commission. In the White Paper, the Commission stated that autonomous agencies would not be appropriate if they were granted “decision-making power in areas in which they would have to arbitrate between conflicting public interests, exercise political discretion, or carry out complex economic assessments,” all of which apply to a determination of the validity of an anti-avoidance rule under the wholly artificial arrangements doctrine.¹⁹⁴ Finally, the ECJ would still retain ultimate authority in interpreting the wholly artificial arrangements doctrine, and would thus be able to strike down improper rulings by such an agency.¹⁹⁵

192. *Commission White Paper on European Governance*, COM (2001) 482 final (July 25, 2001).

193. *Id.* at 24.

194. *Id.*

195. It is not clear how much deference, if any, the ECJ would be required to give to an agency decision. Article 230 authorizes the ECJ to review actions by various EU institutions “on grounds of lack of competence, infringement of an essential procedural requirement, infringement of [the EC] Treaty or of any rule of law relating to its application, or misuse of powers.” EC Treaty, *supra* note 8, art. 230. The Court appears to exercise review agency

2. Codification of the Wholly Artificial Arrangements Doctrine

Another potential remedy that could reduce the federalism concerns inherent in a remedy that depends entirely on the ECJ would be the codification of the wholly artificial arrangements doctrine by the Council of the EU. Codification—or at least discussions of codification—of anti-avoidance rules and doctrines has become fairly common in jurisdictions beyond the EU. In the United States, codification of the economic substance doctrine has been proposed numerous times over the past decade, with supporters lauding the greater certainty and democratic legitimacy that would accompany codification and opponents citing the lack of flexibility and difficulty of administrability associated with codification.¹⁹⁶ Outside of the United States, many countries have codified general anti-avoidance

actions differently in different contexts. Compare Philip A. Akakwam, *The Standard of Review in the 1994 Antidumping Code: Circumscribing the Role of GATT Panels in Reviewing National Antidumping Determinations*, 5 MINN. J. GLOBAL TRADE 277, 288–89 (1996) (“The EU system vests administrative agencies with wide discretion, the exercise of which the European Court of Justice (ECJ) is often reluctant to scrutinize.”) with Henry H. Perritt, Jr., *Providing Judicial Review for Decisions by Political Trustees*, 15 DUKE J. COMP. & INT’L L. 1, 42 (2004) (“Judicial review of administrative agency decisions is a fundamental precept of European Law.”).

196. In the United States, opponents of codification of the economic substance doctrine have pointed to two major problems with such an approach: (i) codification proposals appear to create a higher standard than does the current judge-made economic substance doctrine, and (ii) codification, even were it to incorporate the exact standard used by courts, is not necessarily appropriate for a standard such as the economic substance doctrine. See Keinan, *supra* note 88, at 448 (discouraging codification because “it is questionable whether codification of common law doctrines is the right answer [and] because the current proposal is inconsistent with the majority of court decisions on economic substance”). In regards to the first criticism, commentators, including the Tax Section of the New York State Bar Association (NYSBA Tax Section), have pointed out that recent proposals have set out a far more stringent standard that would likely prohibit many more transactions than are currently disallowed under the economic substance doctrine. See NEW YORK STATE BAR ASSOCIATION, NYSB TAX SECTION COMMENTS ON TREASURY’S PROPOSAL TO CODIFY THE ECONOMIC SUBSTANCE DOCTRINE 19 (July 25, 2000) (stating that the proposal, unlike the economic substance doctrine applied in practice, “denies tax benefits arising from a transaction merely because the taxpayer does not anticipate a pre-tax profit”); Bankman, *supra* note 82, at 26 (stating that “basing a test primarily on the relationship between [tax benefits and nontax] benefits raises problems of its own”); Keinan, *supra* note 88, at 443 (criticizing codification proposals for creating a higher standard than that used by a majority of courts). In regards to the second criticism, one of the major benefits of a judicially created doctrine such as economic substance is its flexibility, and this benefit would be lost were the doctrine codified. When testifying before Congress about the 2004 codification proposal, the Acting Assistant Secretary of Treasury stated that “the doctrine right now is a very flexible doctrine that is applied by the courts as needed.” *Id.* at 451.

rules (GAARs). Both Australia and Canada, for example, have GAARs, which have met with both qualified success and significant criticism.¹⁹⁷

As with the creation of an anti-avoidance agency, codification would reduce the uncertainty currently surrounding the wholly artificial arrangements doctrine. Unlike an agency, however, codification would remove the flexibility inherent in an anti-avoidance doctrine.¹⁹⁸ Codification of the wholly artificial arrangements doctrine would effectively create a bright-line rule as to exactly what level of anti-avoidance rule was permitted in the EU. This switch from an ex post standard to an ex ante rule could have the unintended effect of increased tax planning and perhaps even more aggressive avoidance as taxpayers and their advisors pushed tax avoidance to the limit of the codified doctrine.¹⁹⁹

Furthermore, the EU's federal structure and Member States' concerns over sovereignty mean that codification is extremely unlikely at this juncture. Codification would require the unanimous consent of all twenty-seven Member States and, although such consent would grant legitimacy to the wholly artificial arrangements doctrine, concerns over the sovereignty inherent in direct taxation make such unanimous consent unlikely if not impossible.

3. Anti-Avoidance Test Cases

A third possible approach lies in the hands of Member States. As shown by the cases discussed in Part II, the wholly artificial arrangements doctrine develops as the Court considers direct taxation free movement cases. While many of these cases arrived at the ECJ by way of individual taxpayers challenging Member State measures before their domestic courts, others, such as *Thin Cap GLO* and *CFC Test Claimants*,²⁰⁰ arrived at the Court as test cases referred by domestic courts to gauge the ECJ's approach to anti-avoidance measures. Member State courts could thus make a concerted effort to send an increasing number of anti-avoidance test cases to the Court to clarify the outlines of the wholly artificial arrangements doctrine.

197. See generally Julie Cassidy, "To GAAR or Not to GAAR – That is the Question:" *Canadian and Australian Attempts to Combat Tax Avoidance*, 36 OTTAWA L. REV. 259 (2004).

198. See, e.g., Dennis Ventry, *Save the Economic Substance Doctrine from Congress*, 118 TAX NOTES 1405 (Mar. 31, 2008).

199. For more on this concern in the context of the economic substance doctrine, see generally *id.*

200. C-524/04, 2007 E.C.R. I-2107.

Test cases before the ECJ have led to developments in areas from equality for same-sex partners to protection of copyright to pay discrimination.²⁰¹ Test cases in other areas have come either directly from governments or government agencies, or have involved government agencies educating or assisting individual litigants in order to clarify the outlines of the law or push forward a legal question.²⁰² In the field of direct taxation, certain Member States, such as Germany, the Netherlands and the United Kingdom are currently much more willing than others, such as Ireland, Italy and Spain to send preliminary references to the ECJ.²⁰³ Although this distinction could arguably be based on the former Member States having more problematic direct tax measures than the latter Member States, the disparity is likely due at least as much to willingness on the part of some Member States to make such referrals. Were Member States to overcome their hostility to preliminary references and increase the number and variety of anti-avoidance cases before the European Court of Justice, they would likely force the Court to clarify the wholly artificial arrangements doctrine. Even were some Member State courts unwilling to refer preliminary rulings to the ECJ under Article 234, other Member States could potentially bring a case to the Commission under Article 227. Alternatively, the Commission could exercise its right to bring an enforcement action against a Member State under Article 226.²⁰⁴

201. See Paul L. Spackman, Note and Comment, *Grant v. South-West Trains: Equality for Same-Sex Partners in the European Community*, 12 AM. U. J. INT'L L. & POL'Y 1063, 1066 n.11 (1997) (referring to test cases in fight for equality); Karl Ruping, *Copyright and an Integrated European Market: Conflicts with Free Movement of Goods, Competition Law, and National Discrimination*, 11 TEMP. INT'L & COMP. L.J. 1, 27 (1997) (referring to test case in fighting bootlegs); Erika Szyszczak, *Antidiscrimination Law in the European Community*, 32 FORDHAM INT'L L.J. 624, 637-38 (2009) (charting the development of the "equal pay for equal work" principle in the EU, which "was developed by the Court in a series of test cases . . .").

202. See, e.g., Eva Inés Obergfell, *On Division of Competence in the EU – The Tobacco Advertising Prohibition Directive Test Case*, 1 THE EUROPEAN LEGAL FORUM 153 (2001) (discussing generally the successful test case that Germany brought against the European Parliament and the Council to challenge the Tobacco Advertising Ban Directive); Bob A. Hepple, *Social Rights in the European Economic Community: A British Perspective*, 11 COMP. LAB. L.J. 425, 431 (1990) ("The British and Northern Irish Equal Opportunities Commissions adopted test case strategies, assisting individual complainants in a number of key cases, sometimes in collaboration with trade unions, before the domestic courts and tribunals and the European Court of Justice (ECJ). There has been a dynamic interaction between rulings of the ECJ . . . and decisions of United Kingdom courts, which in turn have been used in the development of EEC equality law.").

203. Pistone, *supra* note 35, at 534.

204. Despite these many remedial avenues, the EC Treaty does not provide a means for

Regardless of what institution brings or refers a test case, however, relying solely on test cases is unlikely to respond adequately to the concerns raised by the wholly artificial arrangements doctrine. First, although Article 234 requires courts of last instance to refer to the ECJ questions of EU law that are necessary to their judgment, critics have pointed out that the lack of a system of appeal for these very courts means that “one could conclude that there is no real obligation to refer.”²⁰⁵ Relying on test cases would also merely mean that the development of the doctrine described in Part II would be accelerated, not that the shape of the doctrine or the way in which it would be applied would necessarily change. The ECJ would still be responsible for interpreting and applying the doctrine, and the Court could continue on its path of vague definitions and unpredictable outcomes. Moreover, test cases would not reduce sovereignty concerns, since the ECJ would remain the ultimate arbiter of anti-avoidance cases, and the Member States would still be ceding their authority over direct taxation to the court. There is also no guarantee that the ECJ would consider all of the test cases. Some commentators argue that the ECJ has effectively developed a justiciability doctrine similar to the U.S. requirement of a legitimate case or controversy, so Member State courts would have to wait for actual cases or controversies to bring test cases.²⁰⁶ Furthermore, as discussed above, Member State courts could ultimately choose not to follow the ECJ’s holdings in test cases, thereby not changing the dynamic currently at work between the ECJ and the Member States over the wholly artificial arrangements doctrine.²⁰⁷

Although this approach would give Member States more control in terms of the initial referral to the Court, it would still raise federalism concerns since the ECJ would retain its current role as final arbiter of the legitimacy of Member State anti-avoidance measures. This approach would also put more Member State measures at risk of

private litigants to bring test cases. They must instead take the indirect route of bringing a case before a Member State court, which can then refer the EU law question(s) to the ECJ under Article 234. See Xavier Lewis, *Standing of Private Plaintiffs to Annul Generally Applicable European Community Measures: If the System is Broken, Where Should It Be Fixed?*, 30 *FORDHAM INT’L L.J.* 1496 (2007) (discussing the limits on the only private right of action, an action for annulment, which is authorized by Article 230).

205. Somek, *supra* note 158, at 633.

206. See King, *supra* note 159, at 731.

207. See Somek, *supra* note 158, at 641 (“The largest problem lies in the fact that national courts still have some ability to disregard rulings of the ECJ.”); see also Hepple, *supra* note 202, at 431 (referring to the “dynamic interaction” between ECJ cases and UK courts in developing “equality law”).

being struck down than would an approach of merely waiting for such measures to be brought before the Court by taxpayer challenges.

C. *Short-Term Response: Adopting a More Flexible Standard*

Until the Member States and institutions of the EU are willing to address the challenges posed by tax avoidance in the EU, both the long-term solutions discussed in Part IV.A and the more moderate approaches discussed in Part IV.B are unlikely to gain much traction. This Article argues, however, that the concerns raised in Part III—for taxpayers, Member States and the EU as a whole—must be addressed. This Part IV.C thus suggests a much more short-term approach to modifying the wholly artificial arrangements doctrine. While this approach will admittedly not solve the ultimate problem of the legislative vacuum created by the doctrine, nor will it assist the constituents of the EU in choosing sovereignty or integration, it will solve some of the concerns with the wholly artificial arrangements doctrine and does not require unanimous consent. Furthermore, since the ECJ is the institution that has created the wholly artificial arrangements doctrine, this approach is fitting since it only requires the involvement of the court. Under this short-term approach, the court would adopt a more flexible approach to anti-avoidance cases that would allow the court to consider the purpose behind the wholly artificial arrangements doctrine, the challenged Member State anti-avoidance rule and the relevant provisions of the EC Treaty.

Although some commentators believe that the ECJ's tax jurisprudence is cyclical and that the court has already pulled back from its most activist stance and begun to approach direct tax cases with more flexibility,²⁰⁸ these analyses of the Court's anti-avoidance cases appear to end with *Oy AA*. As discussed in Part II and Part III, *Oy AA* was unique in that it was the only anti-avoidance case in which the ECJ used the wholly artificial arrangements doctrine to uphold the measure in question.²⁰⁹ Furthermore, cases following *Oy AA* returned the court to its more stringent approach, and the wholly artificial arrangements doctrine was again used to strike down Member State measures.²¹⁰ Without any evidence that the Court's anti-

208. See van Thiel 2008, *supra* note 7, at 181; see also Wattel, *supra* note 168, at 205.

209. See *supra* note 69 and accompanying text.

210. Case C-201/05, *The Test Claimants in the CFC and Dividend Group Litigation v. Comm'rs of Inland Revenue*, 2008 E.C.R. I-02875; Case C-105/07, *Lammers & Van Cleeff NV v. Belgische Staat*, 2008 E.C.R. I-00173; Case C-451/05, *Européenne et Luxembourgeoise d'investissements SA (ELISA) v. Directeur général des impôts, Ministère*

avoidance pendulum has already swung toward greater restraint, therefore, it seems likely that the court will continue to apply the doctrine as it has in every case other than *Oy AA* unless and until it adopts the more flexible standard advocated in this Part IV.C.

The first step that the ECJ could take to remedy some of the problems associated with the doctrine would be to apply the doctrine more consciously and explicitly. Although the U.S. Supreme Court has never referred to the "economic substance doctrine," it has made clear that it considers the economic substance of a transaction,²¹¹ and lower federal courts have referred to the doctrine itself.²¹² While this has evidently not removed the uncertainty over the outlines of the doctrine or its application, it does at least mean that taxpayers in the United States have more guidance than do taxpayers or Member States in the EU. Following on this more explicit application, the ECJ could, in applying the doctrine, more explicitly define its outlines. The court could state outright whether there is a distinction between impermissible tax avoidance and tax evasion, whether the court and domestic courts should apply a subjective prong alongside the objective prong, what explicitly would qualify as a wholly artificial arrangement, and how the court decides whether to act unilaterally or leave the ultimate decision of a measure's legitimacy to a domestic court. This approach may not solve the federalism problems inherent in the court's development of a doctrine used to challenge Member State anti-avoidance measures, since the court itself is still the actor challenging these measures. This approach would, however, reduce the internal inconsistencies and uncertainties currently present in the wholly artificial arrangements doctrine.

The court could also go one step further and adopt a more flexible approach to anti-avoidance cases. This would build on one of the inherent benefits of a judicial doctrine applied *ex ante*. In *Oy AA*, the Court toyed with allowing anti-avoidance rules that applied more broadly than wholly artificial arrangements. For the first time in its application of the wholly artificial arrangements doctrine, the Court suggested that a measure could be proportionate to the justification of preventing tax avoidance even if it was not only meant to target wholly artificial arrangements:

public, 2007 E.C.R. I-08251

211. See, e.g., *Frank Lyon Co. v. United States*, 435 U.S. 561 (1978); *Knetsch v. United States*, 364 U.S. 361 (1960).

212. See, e.g., *Lerman v. Comm'r*, 939 F.2d 44, 54 (3d Cir. 1991) (stating that "[t]he economic substance doctrine has been consistently applied by the courts for many years in a variety of tax situations").

Even if the legislation at issue in the main proceedings is not specifically designed to exclude from the tax advantage it confers purely artificial arrangements, devoid of economic reality, created with the aim of escaping the tax normally due on the profits generated by activities carried out on national territory, such legislation may nevertheless be regarded as proportionate to the objectives pursued, taken as a whole.²¹³

Although the court appears to have backed away from this approach, looking more broadly to the purpose of the wholly artificial arrangements doctrine could prove more favorable in terms of both internal inconsistency and Member State sovereignty. As detailed in Part III, the doctrine emerged out of the court's concern that anti-avoidance rules were infringing on free movement between Member States to a greater degree than was necessary to ensure prevention of tax avoidance. The court moved, however, from the principle of proportionality to a more stringent requirement that anti-avoidance rules be not just proportional to the goal of preventing tax avoidance but that they apply *only* to wholly artificial arrangements. Following the lead of commentators who have suggested that anti-avoidance doctrines in other jurisdictions focus more on legislative purpose,²¹⁴ the ECJ could consider legislative purpose as part of an overall more flexible approach to anti-avoidance cases.

Considering purpose, intent, motive, and similar factors is of course quite controversial in the world of statutory interpretation.²¹⁵ As will be detailed below, however, this Article proposes not the consideration of one specific purpose, but rather a multi-factor flexible approach that takes into account the purposes underlying the wholly artificial arrangements doctrine, the Member State measure, and freedom of movement jurisdiction as a whole. In other words, this Article advocates that, in the short term, the court adopt a flexible standard pursuant to which the inconsistent goals of sovereignty on the one hand and integration on the other be considered in light of the specific Member State anti-avoidance measure in question. Given the impossibility of satisfying all of these interests in any one case, no matter how strict a construction the court adopts, this Article argues that such a flexible standard is the best short-term approach to

213. Case C-231/05, *Oy AA*, 2007 E.C.R. I-06373, ¶ 63.

214. See McCormack, *supra* note 13.

215. See, e.g., William N. Eskridge, Jr., *The New Textualism*, 37 UCLA L. REV. 621 (1990).

a problem that ultimately requires a much larger solution, as discussed in Part IV.A. Furthermore, given that even those who advocate strict construction generally agree that more flexible interpretive approaches are appropriate when considering constitutional provisions,²¹⁶ as well as in the context of taxation,²¹⁷ this Article contends that anti-avoidance cases, which pit the broad free movement provisions of the EC Treaty against the complicated anti-avoidance measures in Member State tax codes, are particularly suited to such an approach.²¹⁸

Rather than focusing on whether the Member State measure applies only to wholly artificial arrangements, the Court should take a broader view and consider: (i) the purposes behind the wholly artificial arrangements doctrine; (ii) the purposes behind the measure in question, and (iii) the purposes behind the Treaty provisions that the ECJ interpreted when it created the doctrine. Since the ECJ itself created the wholly artificial arrangements doctrine, the first consideration would not be a stretch for the Court. Instead, this would merely require a return to applying the principle of proportionality, thereby perhaps allowing more Member State rules to stand if their effect on freedom of movement is not disproportionate to the goal of preventing tax avoidance. Such an approach would likely allow less discriminatory or restrictive measures to remain, even if they extended beyond wholly artificial arrangements. Anti-avoidance rules would thus exist on a spectrum: those that posed significant restrictions on freedom of movement would have to be more narrowly targeted,

216. See Richard A. Posner, *Economics, Politics, and the Reading of Statutes and the Constitution*, 49 U. CHI. L. REV. 263, 282 (1982) (stating that “virtually everyone who writes on the question thinks that constitutional provisions should not be construed as strictly as statutory provisions”).

217. See McCormack, *supra* note 13, at 724–25 (stating that reference to overarching principles to determine the purpose of a provision is more appropriate in “the particularized context of tax law”).

218. While some of the reasons for considering purpose in the context of the Internal Revenue Code do not apply here, *cf.* Deborah A. Geier, *Interpreting Tax Legislation: The Role of Purpose*, 2 FLA. TAX REV. 492, 497 (1995) (referring to the “theoretical construct that overarches the sum total of the entire Internal Revenue Code and is intended to be captured by it”), purpose seems particularly appropriate to anti-avoidance measures being challenged as freedom of movement violations both because of their complexity, *see* Lawrence Zelenak, *Thinking About Nonliteral Interpretations of the Internal Revenue Code*, 64 N.C. L. REV. 623, 664 (1986) (referring to the importance of considering complexity when interpreting a statute), and because of the goals of the common market. In other words, an anti-avoidance measure that was explicitly crafted to discriminate against residents of other Member States could be considered more anathema to the freedom of movement than an anti-avoidance measure used by jurisdictions around the world that happens to implicate freedom of movement.

while those that had less of an effect on integration could prevent more transactions. By allowing some more anti-avoidance rules to remain, this would slightly ameliorate the sovereignty concerns of Member States.

The second and third considerations in this more flexible standard, however, could respond more directly to Member State concerns. Under the second step, the Court would consider whether the Member State measure was actually intended to prevent tax avoidance that was undermining the Member State's ability to raise revenue or otherwise protect its tax base. Although the Member State's intention need not be controlling, consideration of the reasons for the measure would again be likely to lead the Court to uphold more anti-avoidance measures with the actual purpose of preventing tax avoidance, rather than treating all anti-avoidance measures as attempts by Member States to block integration. This inquiry could also consider whether the measure in question was of a type recommended by the OECD or similar to measures in other jurisdictions. Finally, under the third step, the ECJ would consider the purpose underlying the Treaty provisions at issue in anti-avoidance cases, including Article 94 (reserving Member State sovereignty) and Article 234 (granting the ECJ jurisdiction). The Court would consider whether, in reserving autonomy over direct taxation, Article 94 was intended to allow any and all anti-avoidance rules that encroach on free movement or, whether, in granting the ECJ jurisdiction to hear all preliminary rulings involving Treaty interpretation, regardless of the areas of law that they raise, Article 234 was intended to remove restrictions to free movement even in areas covered by Article 94. This approach would raise numerous questions, many of which are currently being debated in the literature on direct taxation in the EU.²¹⁹ Whose intent should the Court consider—the original parties to the Treaty, or the parties that renewed the relevant Articles in subsequent treaties? Could the original drafters have foreseen the push toward integration that resulted from the Court's jurisdiction? Can the Court, itself the engine of integration in many areas of the law, objectively judge the purposes behind the relevant Treaty provisions? Regardless of these questions, however, considering the overall purpose of the Treaty when applying the wholly artificial arrangements doctrine would more directly respond to concerns that the Court is impermissibly expanding into the area of direct taxation in violation of Member States' expectations. This inquiry could also welcome

219. See, e.g., Kaye, *supra* note 33; van Thiel 2008, *supra* note 7; Wattel, *supra* note 168.

the input of other Member States and EU institutions regarding their own interpretations of the purposes of the relevant Treaty provisions. Such a response may still not be sufficient for sovereignty-conscious Member States, however, if the Court's involvement in direct taxation, even when applying a purposive approach, is itself seen as a threat to sovereignty.

This flexible approach does raise its own concerns and is thus only a short-term response while the Member States and institutions of the EU gather the support for other longer-term responses. First, it is unclear whether the ECJ would adopt a more flexible approach. The proposed jurisdiction-stripping and threat of Member State nullification may be sufficient to encourage the Court to move toward this approach, however, particularly when combined with the Court's general trend of moving back toward flexibility and deference to Member States after strongly pro-integration decisions.²²⁰ Second, the threat of the legislative vacuum created by the doctrine may be necessary for any long-term agreement. Were this flexible approach to replace the doctrine, it is possible that Member States and institutions could lose the incentive to strike a balance between sovereignty and integration. While this is possible, however, the flexible approach is likely to maintain uncertainty and unlikely to allow all anti-avoidance rules to stand. As such, Member States and institutions are still likely to push toward a more definite long-term solution even in the context of this more purposive approach.

As a first step toward addressing the concerns raised by the wholly artificial arrangements doctrine and slowing the need for ultimate agreement over sovereignty or integration in the area of direct taxation, applying a more flexible standard that considers proportionality, Member State intent, and the purpose of the relevant Treaty provisions would allow the ECJ to retain its general jurisdiction while still allowing Member States the ability to police tax avoidance. Note that, in proposing this more flexible approach, this Article does not try to engage in the ongoing debate between purpose, intent, and motive, all of which different commentators distinguish in different ways.²²¹ Instead, the Article argues that the ECJ should take a purposive, flexible approach, with the goal of striking the best possible balance between sovereignty, integration, and tax avoidance, given the impossibility of striking an ideal balance without greater input from Member States and the EU as a whole. The Court would still be able to strike down measures that disproportionately restrict

220. See, e.g., Wattel, *supra* note 168, at 205.

221. See, e.g., McCormack, *supra* note 13, at 730 (distinguishing between purpose and intent); Posner, *supra* note 216, at 272 (distinguishing between intent and motive).

freedom of movement or are intended more as a barrier to integration than as a way to police tax avoidance, but this ability would be tempered by consideration of the reasons for the Court's jurisdiction, as well as the Member State's intentions in passing the measure.

V. CONCLUSION

The ECJ's creation of a European anti-avoidance doctrine is fraught with problems. Taxpayers in the EU face greater tax avoidance. Member States face a loss of both the ability to raise revenue and the sovereignty to prevent tax avoidance. Ultimately, the EU legal order as a whole faces a decision between sovereignty over direct taxation and greater integration in the fight against tax avoidance. Until the Member States and member institutions of the EU make this decision, this Article argues that the best response available to the ECJ is a replacement of the wholly artificial arrangements doctrine with a more flexible approach. Such an approach will ameliorate the conflict between integration and sovereignty and allow the EU to consider other approaches to policing tax avoidance while not threatening the future of the EU.