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Income Tax Discrimination and the Political and Economic of Europe

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MICHAEL J. GRAETZ AND ALVIN C. WARREN, JR.

Income Tax Discrimination and the Political and Economic Integration of Europe

ABSTRACT. In recent years, the European Court of Justice (ECJ) has invalidated many income tax law provisions of European Union (EU) member states as violating European constitutional treaty guarantees of freedom of movement for goods, services, persons, and capital. These decisions have not, however, been matched by significant EU income tax legislation, because no EU political institution has the power to enact such legislation without unanimous consent from the member states. In this Article, we describe how the developing ECJ jurisprudence threatens the ability of member states to use tax incentives to stimulate their domestic economies and to resolve problems of international double taxation. We conclude that the ECJ approach is ultimately incoherent because it is a quest for an unattainable goal in the absence of harmonized income tax bases and rates: to eliminate discrimination based on both origin and destination of economic activity. We also compare the ECJ's jurisprudence with the resolution of related issues in international taxation and the U.S. taxation of interstate commerce, and we consider the potential responses of both the European Union and the United States to these developments.

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INTRODUCTION

Whither Europe? That is the question newspapers and pundits asked repeatedly after the French and the Dutch rejected the proposed European Constitution in the summer of 2005. But that question was a perplexing one long before these summer setbacks. And, even if the new constitution is ultimately approved, the question will persist. Here, we explore one critical aspect of European integration, focusing on the tax aspects of European constitutional arrangements set out in the European treaties—arrangements that will remain unchanged under the new constitution if it is eventually ratified. Our principal conclusion is that the European Court of Justice (ECJ) is undermining the fiscal autonomy of member states by articulating an interpretation of income tax arrangements that is ultimately unstable. In particular, the court has invalidated a number of European Union (EU) member state tax provisions in a manner that unsettles member states' longstanding mechanisms for both avoiding international double taxation and protecting against international tax avoidance. The court's decisions also threaten the ability of member states to use tax incentives to stimulate their economies.

The actions of the ECJ must be understood within Europe's broader institutional context. The court's tax doctrine rests on its interpretation of the central freedoms guaranteed by Europe's governing treaties. With the Treaty of Rome in 1957, six countries—Belgium, France, (West) Germany, Italy, Luxembourg, and the Netherlands—came together to form a “common market” known as the European Economic Community.¹ In addition to “mak[ing] war unthinkable” in Western Europe,² the motivating idea of this treaty was to increase economic interdependence, primarily through increased trade between these member states. In 1973, the United Kingdom, Ireland, and Denmark joined; Greece entered in 1981, followed by Spain and Portugal in 1986. These twelve members agreed to the Single European Act of 1986, which defined an area committed to “the free movement of goods, persons, services and capital.”³ These are frequently labeled the “four freedoms,” and they are

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1. Treaty Establishing the European Economic Community, Mar. 25, 1957, 298 U.N.T.S. 11 (entered into force Jan. 1, 1958). The Treaty of Rome was itself a successor to the 1951 Treaty of Paris, Apr. 18, 1951, 261 U.N.T.S. 140, which established the European Coal and Steel Community, comprising the same six nations and eliminating tariffs on coal and steel.
 2. ALEC STONE SWEET, *THE JUDICIAL CONSTRUCTION OF EUROPE* 46 (2004).
 3. Single European Act art. 13, Feb. 17, 1986, 1987 O.J. (L 169) 1. The Treaty Establishing the European Community, Nov. 10, 1997, 1997 O.J. (C 340) 3, incorporated the guarantees of the Single European Act: freedom of movement for workers, *id.* art. 39, freedom of

now incorporated into the European Community (EC) Treaty and included in the proposed European Constitution.⁴

Subsequent treaties expanded the European experiment and established various institutions to advance its mission. In 1992, the Treaty of Maastricht created the EU—a political union cooperating in foreign policy, defense, and criminal law, in addition to economic relations.⁵ The same year, a majority of member states adopted the Euro as the EU's currency and established a new European central bank to supply a common monetary policy throughout most of the Union. The monetary union agreement also imposed specific budgetary responsibilities on the member states. Through the Stability and Growth Pact, these countries agreed to limit their fiscal deficits to three percent of GDP—a limitation that has proved unenforceable.⁶ Membership in the EU now stands at twenty-five, and twelve member states use the Euro as their common currency.⁷

The political and legal institutions that govern the EU do not fit easily into familiar categories. Some scholars describe the EU as a pooling of sovereignty.⁸

establishment, *id.* arts. 43, 48, freedom to provide services, *id.* art. 49, and freedom of movement of capital, *id.* arts. 56, 58.

4. Article I-4 of the Treaty Establishing a Constitution for Europe states: "The free movement of persons, services, goods and capital, and freedom of establishment shall be guaranteed within and by the Union, in accordance with the Constitution." Treaty Establishing a Constitution for Europe, art. I-4, Oct. 29, 2004, 2004 O.J. (C 310) 1.
5. The EU expanded to fifteen members by adding Austria, Finland, and Sweden in 1995. The Treaty of Amsterdam in 1997 consolidated and renumbered the articles of the EU and the EC treaties, and in 2001 the Treaty of Nice somewhat revised the EU's governance in anticipation of its expansion to at least twenty-five members. See Treaty of Amsterdam Amending the Treaty on European Union, the Treaties Establishing the European Communities and Certain Related Acts, Oct. 2, 1997, 1997 O.J. (C 340) 1; Treaty of Nice Amending the Treaty on European Union, the Treaties Establishing the European Communities and Certain Related Acts, Feb. 26, 2001, 2001 O.J. (C 80) 1. For subsequent citations to articles in the European treaties, we refer to the Consolidated Version of the Treaty Establishing the European Community, Dec. 24, 2002, 2002 O.J. (C 325) 33 [hereinafter EC Treaty]. For further background, see RUTH MASON, PRIMER ON DIRECT TAXATION IN THE EUROPEAN UNION 1-3 (2005). The European treaties (and Europe's proposed constitution) can be amended (or adopted) only through the unanimous vote of the member states, typically followed by ratification at the national level either by the national legislature or by a referendum.
6. See, e.g., Martin Feldstein, *The Euro and the Stability Pact* (Nat'l Bureau of Econ. Research, Working Paper No. 11,249, 2005).
7. In addition to the countries already mentioned, EU members include Cyprus, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovakia, and Slovenia.
8. E.g., Robert O. Keohane & Stanley Hoffmann, *Institutional Change in Europe in the 1980s*, in THE NEW EUROPEAN COMMUNITY 1, 7 (Robert O. Keohane & Stanley Hoffmann eds., 1991).

Others regard it as a blend of international law, national constitutional law, and federalism.⁹ In any event, the rights and obligations of the treaties apply to the member states and to the citizens of those states, as well as to the EU's governing institutions.¹⁰

There are four organizations that promulgate and enforce EU rules: (1) the European Parliament (Parliament), which is the only EU governing institution whose members are directly elected by the people;¹¹ (2) the European Council of Members (Council), which is composed of sitting ministers of member state governments who have the authority to bind their member states; (3) the European Commission (Commission), which has the exclusive power to draft and propose legislation and to implement EU policy; and (4) the ECJ (formerly the Court of Justice of the European Communities), which serves as the EU's constitutional court.

The unique institutional structure of the EU has limited the ability of legislative bodies to formulate member state income tax policy while permitting the ECJ to take a prominent role. In sum, neither the Parliament, the Council, nor the Commission has the authority to adopt Europe-wide income tax measures without a level of consensus that is typically not achievable except in technical and relatively uncontroversial matters. Although the treaties have increasingly involved the Parliament in legislation and have expanded its powers over time (as a way of narrowing Europe's democracy deficit), its authority remains limited. Most of Parliament's enactments must be approved by the Council before taking effect.¹²

Though the Council—considered the EU's “intergovernmental center of gravity”¹³—has the power to regulate commerce among member states and to decide other issues, its authority is also circumscribed. The finance ministers of the member states make up the Economic and Financial Affairs Council (ECOFIN), which has responsibility for tax matters,¹⁴ but they cannot act on income tax issues without unanimous agreement. Consequently, any member

9. E.g., James A. Caporaso, *The European Union and Forms of State: Westphalian, Regulatory or Post-Modern?*, 34 J. COMMON MKT. STUD. 29 (1996); Alberta M. Sbragia, *The European Community: A Balancing Act*, PUBLIUS, Summer 1993, at 23.

10. Case 26/62, *N.V. Algemene Transport—en Expeditie Onderneming van Gend & Loos v. Nederlandse administratie der belastingen*, 1963 E.C.R. 1.

11. The Parliament's 732 members serve five-year terms. MASON, *supra* note 5, at 4-6.

12. See Tracy A. Kaye, *Tax Discrimination: A Comparative Analysis of U.S. and EU Approaches*, 7 FLA. TAX REV. (forthcoming 2006) (manuscript at 11, on file with authors).

13. STONE SWEET, *supra* note 2, at 47.

14. MASON, *supra* note 5, at 7 n.57.

state can veto any proposal.¹⁵ In addition, before issuing “directives” or regulations on tax matters, the Council is required to consult with Parliament and the Economic and Social Committee, which is an advisory body consisting of 350 people who represent “various categories of economic and social activity.”¹⁶

The Council is further constrained by the fact that it can act only on proposals of the Commission (although it can request that the Commission study specific issues). There are twenty-five commissioners, one from each member state. Rather than representing a particular country, each commissioner is responsible for a substantive area of EU legislation and regulation. The Commission is the moving force behind most policy initiatives and has often announced its tax policy goals in communications to the Council, the Parliament, and the Economic and Social Committee.¹⁷ The Commission also represents the EU in international organizations including the Organization for Economic Cooperation and Development (OECD) and the World Trade Organization (WTO). Upon a recommendation of the Commission, the Council—subject to the unanimity and consultation requirements—may issue directives on tax matters. Needless to say, adopting directives is a slow and cumbersome process, subject to the veto of any member state, and, as a result, only a few income tax directives have been issued.¹⁸

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15. An early draft of the proposed European Constitution would have allowed majority voting on corporate income tax provisions, but the final draft retained the unanimity requirement, on which the United Kingdom and Ireland insisted. Brian Groom & Peter Norman, *EU Leaders Draw Up Outline Deal on Treaty Revisions*, FIN. TIMES, Dec. 11, 2000, at 1. On other issues, Council decisions are made by simple majority, qualified majority, or unanimous vote, depending on the subject matter. The most common procedure is a qualified majority vote, which requires both a majority of member states (or in some cases, a two-thirds majority) and a minimum of 72.3% of total votes. Any member state may also insist that the vote represent 62% of the EU population in order to take effect. MASON, *supra* note 5, at 7; STONE SWEET, *supra* note 2, at 47. Votes in the Council are weighted, generally by the country’s size. There are a total of 321 votes. For example, Germany, Italy, and the United Kingdom have 29 votes each, while Slovenia has 4. The presidency of the Council rotates every six months among the member states.
 16. EC Treaty art. 257.
 17. *E.g.*, *Communication from the Commission to the Council, the European Parliament and the Economic and Social Committee: Tax Policy in the European Union—Priorities for the Years Ahead*, COM (2001) 260 final (May 23, 2001) [hereinafter *Communication on Tax Policy Priorities*].
 18. There are a few directives applicable to the taxation of corporate income. *E.g.*, Council Directive 2003/49, 2003 O.J. (L 157) 49 (concerning interest and royalty payments between related companies); Council Directive 90/434, 1990 O.J. (L 225) 1, as amended by Council Directive 2005/19, 2005 O.J. (L 58) 19 (concerning mergers); Council Directive 90/435, 1990 O.J. (L 225) 6, as amended by Council Directive 2003/123, 2004 O.J. (L 7) 41 (concerning

However, the Commission does have an alternative to these labyrinthine procedures. The Commission—whose members are required to act independently of their member states' governments and to promote the EU's interests¹⁹—has the power to initiate enforcement actions against member states and often brings cases to the ECJ.

The ECJ has jurisdiction to resolve disputes between member states, between EU institutions and member states, and between the various EU institutions. Its twenty-five judges also hear cases involving issues of European law referred to it by the national courts of the member states. Judges are appointed by each of the member states for a renewable six-year term. The ECJ cases we shall discuss here are generally either (1) actions brought by the Commission against a member state claiming that the member state's law violates one or more of its obligations under the EC Treaty or (2) requests by national courts for an ECJ ruling interpreting European legal or treaty requirements in lawsuits involving private parties. Eight advocates general serve the court by issuing opinions on cases before the court itself acts. Much of the time the court follows the opinion issued by the advocate general. ECJ decisions are rendered by a majority vote, and neither the vote nor any dissenting opinions are published.²⁰ To date, the ECJ has decided more than one hundred cases involving income tax issues, with the vast majority striking down member states' tax provisions on the ground that they violate either one of the four freedoms guaranteed by the treaties or the treaties' bar against discrimination on the basis of nationality.

While the EU's basic separation of powers is familiar to Americans, its specific contours are not. Stripped of all political, social, and economic context, one would be hard pressed to predict whether these institutions would generally operate to expand supranational governance over the member states or to inhibit it. But—at least until the ratification setbacks of the summer of 2005—both European politics and the growing social and economic interdependence within the EU have promoted integration, with greater power and control moving toward the center. Removing barriers to trade, investment, work, and immigration within the EU, along with unifying most of its

parent-subsidiary taxation); *see also* Council Directive 2003/48, 2003 O.J. (L 157) 38 (concerning savings); Council Directive 77/799, 1977 O.J. (L 336) 15, as amended by Council Directive 79/1070, 1979 O.J. (L 331) 8, and Council Directive 92/12, 1992 O.J. (L 76) 1 (concerning mutual assistance).

19. EC Treaty art. 213.

20. For a comparison of French, U.S., and ECJ decisions, see MITCHEL DE S.-O.-L'E. LASSER, *JUDICIAL DELIBERATIONS: A COMPARATIVE ANALYSIS OF JUDICIAL TRANSPARENCY AND LEGITIMACY* (2004).

monetary system, has produced enormous momentum toward the political center.

The institution that has, so far at least, most spurred such centripetal force has been the ECJ. We agree generally with Alec Stone Sweet's conclusion that the ECJ has transformed the EU, enhancing its supranational power and "federalizing" its policy.²¹ As he puts it: "Today, the ECJ has no rival as the most effective supranational judicial body in the history of the world, comparing favorably with the most powerful constitutional courts anywhere."²² More than two decades ago Eric Stein famously summed up the ECJ's work: "Tucked away in the fairyland Duchy of Luxembourg and blessed, until recently, with benign neglect by the powers that be and the mass media, the Court of Justice of the European Communities has fashioned a constitutional framework for a federal-type structure in Europe."²³

There is now emerging, however, a serious question about whether the ECJ can (or will) continue to move political and economic power away from the member states to the EU's governing institutions. Through its decisions in income tax cases, the ECJ is bumping headlong into the member states' retained power to tax and their veto power over any European tax legislation. Individual member states have held on fiercely to their sovereign right to impose income taxes even as they have integrated economically in their treaties through free trade and the free movement of workers, residents, goods, services, and capital (and through the monetary union). The ECJ has the power only to negate tax provisions of member states. No European institution has the power to mandate income tax rules—except with unanimous consent from the member states. However, by striking down specific income tax provisions of the member states as incompatible with the EU treaties—generally with little regard for the internal logic or consistency of member state

21. STONE SWEET, *supra* note 2, at 1.

22. *Id.* Miguel Poiars Maduro goes further to argue that the ECJ engages in "majoritarian activism" and "judicial harmonisation" to reach a regulatory balance that normally corresponds to the view of the Commission and to legislation in the majority of member states. MIGUEL POIARES MADURO, *WE THE COURT: THE EUROPEAN COURT OF JUSTICE AND THE EUROPEAN ECONOMIC CONSTITUTION* 68 (1998). Maduro writes: "The conclusion to be drawn is that what is taking place in the Court is a kind of Community legislative process, with the Court trying to harmonise national rules in accordance with an 'ideally drafted' representation of all States' interests." *Id.* at 78. As will become apparent later in this Article, we do not find that Professor (now Advocate General) Maduro's description is apt in the context of the ECJ's income tax decisions. See *infra* Parts III-IV.

23. Eric Stein, *Lawyers, Judges and the Making of a Transnational Constitution*, 75 *AM. J. INT'L L.* 1, 1 (1981); cf. J.H.H. Weiler, *The Transformation of Europe*, 100 *YALE L.J.* 2403 (1991) (arguing that the transformation of Europe must also be understood as a political process).

tax systems or for the effects on their finances—the ECJ is eroding the member states’ veto power over any European authority to conform or harmonize member state income taxes.

An irresistible force is now confronting an immovable object. The ultimate question is whether the current mixture of unification and separatism can endure. If not, what are the implications for the future of Europe? As we shall show in some detail, this is the fundamental issue raised by the income tax decisions of the ECJ. We begin by analyzing those decisions and identifying the negative legal and fiscal policy implications for member states. We then consider the potential responses of both the European Union and the United States.

I. COMPANY TAXATION IN THE EUROPEAN COURT OF JUSTICE

To an American reader, the description of ECJ cases that follows will sound somewhat familiar. It echoes to some degree cases decided by the Supreme Court under our own Constitution.²⁴ But, rather than tracing these doctrinal analogues, we shall instead examine these decisions through the lens of nondiscrimination—a concept developed principally through the ECJ’s interpretations of the four freedoms. Since our concern here is not with a doctrinal analysis of the ECJ’s decisions but with the implications of its jurisprudence for the economic and political future of Europe (and for the trading partners of Europe, including the United States), we are selective in our analysis of ECJ cases—confining our discussion largely to ECJ decisions involving corporate and shareholder income taxes. Empirical evidence now makes clear that companies’ decisions about where to locate facilities are responsive to corporate income tax differences,²⁵ and it has become commonplace for nations to use corporate taxes as a means of competing for such facilities. We begin by showing how the ECJ has adopted a different and more expansive view of nondiscrimination than is demanded by international trade and income tax agreements.

24. See *infra* Section IV.A.

25. See, e.g., James R. Hines, Jr., *Taxation and U.S. Multinational Investment*, 2 TAX POL’Y & ECON. 33 (1988).

A. *Discrimination Against International Commerce Under International Trade and Tax Treaties*

There are three principal ways in which a country might use its income tax to discriminate against international commerce. It could favor domestic products over foreign products, domestic producers over foreign producers, or domestic production over foreign production.²⁶

Discrimination against foreign products (including services) is the domain of the multilateral treaties, such as the General Agreement on Tariffs and Trade (GATT) and its successors (enforced by the WTO), that govern international trade.²⁷ These agreements limit not only tariffs on imports, but also subsidies for exports, which are sometimes thought to favor domestic products over foreign products in foreign markets. Income tax incentives for exports are subject to these limits, as the United States has learned on several occasions.²⁸ Whether the GATT should be read to constrain other income tax provisions is more controversial.²⁹ If so, the agreements could inhibit a country from limiting income tax benefits, such as accelerated depreciation or investment tax credits, to machinery and equipment produced locally.

Income tax discrimination against foreign producers is the domain of the bilateral treaties that govern international tax relations.³⁰ These agreements

26. For a fuller discussion of these possibilities, see Alvin C. Warren, Jr., *Income Tax Discrimination Against International Commerce*, 54 *TAX L. REV.* 131 (2001).

27. Multilateral Agreements on Trade in Goods, Apr. 15, 1994, Marrakesh Agreement Establishing the World Trade Organization, Annex 1A, Legal Instruments—Results of the Uruguay Round, 33 *I.L.M.* 1125, 1154 (1994); General Agreement on Trade in Services, Apr. 15, 1994, Marrakesh Agreement Establishing the World Trade Organization, Annex 1B, Legal Instruments—Results of the Uruguay Round, 33 *I.L.M.* 1125, 1167 (1994); Agreement on Trade-Related Aspects of Intellectual Property Rights, Apr. 15, 1994, Marrakesh Agreement Establishing the World Trade Organization, Annex 1C, Legal Instruments—Results of the Uruguay Round, 33 *I.L.M.* 1125, 1197 (1994); General Agreement on Tariffs and Trade, Oct. 30, 1947, 61 *Stat. A-11*, 55 *U.N.T.S.* 194.

28. See, e.g., Paul R. McDaniel, *Trade Agreements and Income Taxation: Interactions, Conflicts, and Resolutions*, 57 *TAX L. REV.* 275 (2004) (tracing the history of the GATT and WTO decisions holding that U.S. tax preferences were impermissible export subsidies under the trade treaties).

29. The more recent GATT treaties provide exceptions from trade treaty obligations for income tax and tax treaty provisions. See Reuven S. Avi-Yonah, *Treating Tax Issues Through Trade Regimes*, 26 *BROOK. J. INT'L L.* 1683 (2001); Servaas van Thiel, *General Report*, in *WTO AND DIRECT TAXATION* 13, 17-25 (Michael Lang et al. eds., 2005).

30. See ARTICLES OF THE MODEL CONVENTION WITH RESPECT TO TAXES ON INCOME AND ON CAPITAL art. 24 (Org. for Econ. Cooperation & Dev. 2005) [hereinafter OECD MODEL CONVENTION], available at <http://www.oecd.org/dataoecd/50/49/35363840.pdf>. There are

typically prohibit a country in which income is produced (usually called the source country) from taxing foreign enterprises operating in that country more heavily than similarly situated domestic enterprises.³¹ A source country could not therefore tax business income earned in that country by a foreign company at a rate higher than that applied to comparable income earned by a domestic company. Nor could a source country limit income tax benefits, such as accelerated depreciation or investment tax credits, to machinery and equipment owned by domestic companies.

Neither trade nor tax treaties prohibit discrimination against domestic companies' income from foreign production. Such discrimination will arise if a company's home country (the residence country) taxes the company's foreign income more heavily than its domestic income. Rather than treating a residence country's taxation of its enterprises' foreign income as a matter of discrimination, the tax treaties conceptualize the problem as international double taxation, which arises because both source and residence countries can assert taxing jurisdiction. Framing the issue this way has obscured the analysis of whether foreign production is being treated better or worse than domestic production, because the baseline of equivalent treatment often is not explicitly articulated.

There are two standard residence-country methods for reducing double taxation of foreign income under both national law and the bilateral tax treaties.³² The first is to tax foreign income, but then to grant a tax credit for

more than 2500 bilateral tax treaties in effect, mostly between developed countries. These treaties generally have in common the key structural features of the OECD Model Convention. See KEES VAN RAAD, *NONDISCRIMINATION IN INTERNATIONAL TAX LAW* (1986); Mary Bennett, *Nondiscrimination in International Tax Law: A Concept in Search of a Principle*, 59 *TAX L. REV.* (forthcoming 2006) (manuscript at 5, on file with authors).

31. Because the focus of this Article is income taxation, it is natural to think of tax discrimination against foreign persons as being against foreign producers. Other kinds of tax discrimination against foreign persons are, however, conceivable. For example, a country might impose a special tax on domestic hotel rooms rented by foreign persons, whether the hotel was owned by domestic or foreign interests.
32. A third possibility emerges from the concept of "national neutrality," which argues for a deduction for foreign taxes, rather than a credit or exemption, to alleviate international double taxation. The key idea here is that domestic and foreign taxes are different because a country benefits only from the taxes it collects. From this perspective, domestic income before taxes should be compared with foreign income after taxes, so a deduction for the latter is appropriate. If equal treatment after deduction for foreign taxes (and national neutrality) were considered the appropriate baseline, the credit and exemption methods of alleviating double taxation would favor foreign over domestic production. From the perspective of those two methods, however, alleviating double taxation by a deduction for foreign taxes, which is not acceptable under the typical tax treaty, would discriminate against foreign production. Although not explicitly framed as a nondiscrimination

taxes paid on such income in the source country (a foreign tax credit). The most common rationale offered for this method is capital export neutrality, under which a company should pay the same marginal rate of taxation on its income from investment at home and abroad. The goal of this approach is to subject all of a taxpayer's business activity to the same overall level of taxation, regardless of the location of the investment. However, to avoid refunding taxes paid to another nation, the foreign tax credit is generally limited to the rate of tax in the residence country,³³ so investment abroad will bear a heavier tax burden than investment at home if the source country's tax rate is higher.

The second method for reducing international double taxation is for the residence country to exempt foreign income. The usual rationale offered here is capital import neutrality, which requires that all investments in a given country bear the same marginal rate of income taxation, regardless of the residence of the investor. This approach would subject all business activity within a specific country to the same overall level of taxation, whether the activity is conducted by a resident or a foreigner.³⁴

Under the foreign tax credit (and capital export neutrality), a residence country should not treat foreign production any worse than domestic production, given the baseline of equal after-tax returns. On the other hand, under an exemption for foreign income (and capital import neutrality), a residence country may treat foreign production better than domestic production to achieve equal treatment with domestic production in the source country, given the same baseline.

Other than mandating relief of international double taxation by a credit or exemption, there is no provision in the international trade and tax treaties that explicitly precludes a residence country from discriminating against foreign production by its nationals, whatever the appropriate baseline. Suppose that a residence country that used a foreign tax credit to eliminate international double taxation also applied higher rates to foreign income than to domestic income. Although this result would not be consistent with the capital export neutrality rationale usually thought to underlie the credit, such a provision would not seem to violate any obligation of the treaties unless the higher rate

requirement, the treaty requirement of either a credit or exemption could, from this perspective, be considered such a requirement. See PEGGY BREWER RICHMAN, *TAXATION OF FOREIGN INVESTMENT INCOME: AN ECONOMIC ANALYSIS* (1963).

33. *E.g.*, I.R.C. § 904 (West Supp. 2005).

34. For more on capital export and import neutrality, as well as a critical evaluation of the role these concepts play in the analysis of international taxation, see Michael J. Graetz, *Taxing International Income: Inadequate Principles, Outdated Concepts, and Unsatisfactory Policies*, 54 *TAX L. REV.* 261 (2001).

effectively eliminated the benefit of the credit. Rather than taxing foreign income more heavily, the more common practice is to offer tax benefits for domestic income. An example of this form of discrimination in the U.S. tax code is the deduction for nine percent of "income attributable to domestic production activities."³⁵ For economic policy reasons, the United States has chosen in this provision to favor domestic over foreign production by U.S. taxpayers—a preference that is not precluded by the trade and tax treaties. Another example of this sort of preference is the common limitation of income tax incentives, such as accelerated depreciation or investment tax credits, to machinery and equipment used domestically.³⁶

To recapitulate, trade and tax treaties forbid nations from adopting two of three discriminatory practices. Trade treaties constrain discrimination against foreign products or, correlatively, in favor of domestic exports. The nondiscrimination concept in the tax treaties prohibits source-country discrimination against foreign producers. However, neither the trade nor the tax treaties prevent a residence country from favoring domestic production over foreign production by its own taxpayers. In the next Section, we show that the ECJ's jurisprudence is consistent with international practice on the first two of these dimensions. On the third, however, the ECJ has gone further, limiting the ability of member states to favor domestic over foreign production by their own companies. After analyzing both the legal and fiscal policy implications of the ECJ decisions, we will consider comparable decisions of the U.S. Supreme Court invalidating state tax laws that discriminate against interstate commerce.

B. The Corporate Income Tax Decisions of the ECJ

As previously indicated, the principal legal basis for the ECJ corporate income tax decisions is the EC Treaty's guarantee of freedom of movement for goods, persons, services, and capital. The Treaty also provides for nondiscrimination based on nationality,³⁷ and precludes internal taxation of other member states' products in excess of taxation of domestic products,³⁸ as

35. I.R.C. § 199 (West Supp. 2005).

36. E.g., I.R.C. § 168(b), (g)(1)(A), (g)(2) (West 2002 & Supp. 2005) (providing slower depreciation for tangible property used outside the United States).

37. EC Treaty art. 12.

38. *Id.* art. 90.

well as government subsidies (“state aid” in the language of the EC Treaty) incompatible with an internal market.³⁹

Our goal in this Section is to show that the ECJ decisions can be understood to prohibit discrimination on all three of the dimensions described above, a much more robust approach than that found in international trade and tax law. We do not, therefore, classify the decisions in terms of the various treaty freedoms or rights.⁴⁰ Nor do we distinguish nationality discrimination from market restriction, a distinction sometimes deployed by the ECJ and its European commentators.⁴¹ More recent analyses suggest a growing awareness that these various rights and obligations taken together constitute a general prohibition of discrimination against commerce among member states.⁴² In the language of a recent advocate general’s opinion, national laws “must not result in less favourable treatment being accorded to transnational situations than to purely national situations.”⁴³ It is in that spirit that we organize the ECJ decisions in terms of discrimination against foreign products, producers, and production. Our discussion is selective, rather than exhaustive, because our goal is simply to show that the ECJ jurisprudence occupies all three categories.

The court has long invalidated member states’ laws or regulations that effectively discriminate against foreign products. One celebrated example is

39. *Id.* art. 87.

40. For classifications of the cases by Treaty freedom, see, for example, MATTIAS DAHLBERG, *DIRECT TAXATION IN RELATION TO THE FREEDOM OF ESTABLISHMENT AND THE FREE MOVEMENT OF CAPITAL* 71-83 (2005); ADOLFO J. MARTÍN JIMÉNEZ, *TOWARDS CORPORATE TAX HARMONIZATION IN THE EUROPEAN COMMUNITY: AN INSTITUTIONAL AND PROCEDURAL ANALYSIS* 205-257 (1999); and MASON, *supra* note 5, at 37-92.

41. In European parlance, “discrimination” sometimes refers only to discrimination on the basis of nationality, and “restriction” to other cases in which cross-border income is taxed more heavily than domestic income. This distinction maps roughly, but not exactly, onto our distinction between discrimination against foreign producers (incoming investment) and foreign production (outgoing investment). See, e.g., DAHLBERG, *supra* note 40, at 107-13, 327-29.

42. See, e.g., MICHEL DE WOLF, *SOVERAINETÉ FISCALE ET PRINCIPE DE NON DISCRIMINATION* 453-54 (2005); Hans-Jürgen Aigner et al., *General Report*, in *CFC LEGISLATION, TAX TREATIES AND EC LAW* 13, 38-43 (Michael Lang et al. eds., 2004); Axel Cordewener et al., *The Tax Treatment of Foreign Losses: Ritter, M & S, and the Way Ahead (Part Two)*, 44 *EUR. TAX’N* 218 (2004).

43. Case C-446/03, *Marks & Spencer plc v. Halsey*, ¶ 37 (Apr. 7, 2005) (opinion of Advocate General Maduro), <http://www.curia.eu.int/en/content/juris/index.htm> (search for “Case C-446/03”). Advocate General Maduro also stated that the different criteria established by the ECJ for application of the Treaty freedoms, such as market access and nondiscrimination based on nationality, “all spring from the same source of inspiration which appears to me to be to prevent Member States from creating or maintaining in force measures promoting internal trade to the detriment of intra-community trade.” *Id.* ¶ 39.

Rewe-Zentral AG v. Bundesmonopolverwaltung für Branntwein (more commonly referred to as *Cassis de Dijon*),⁴⁴ in which Germany had refused importation of a French liqueur because it did not meet a requirement of minimum alcohol content applicable to both domestic and foreign products. The court annulled the German provision on the ground that it effectively restricted importation of goods produced in another member state.⁴⁵ An early decision invalidating an income tax provision because it discriminated against a foreign product or service is *Commission v. France*,⁴⁶ in which certain French business deductions for newspapers were conditioned on the newspaper having been printed within France. The court reasoned that the provision was likely to restrict imports of publications printed in other member states, therefore having an effect equivalent to a restriction on imports. Other provisions the ECJ has held to violate the EC Treaty by taxing imported products and services more heavily than their domestic counterparts include:

Sweden imposed a fifteen percent tax on premiums paid by Swedish residents to foreign life insurance companies, but not on premiums paid to Swedish companies.⁴⁷

Germany imposed a tax on German lessees of equipment, such as airplanes, but only if the lessors were foreign.⁴⁸

Denmark imposed greater restrictions on business deductions for meetings at foreign tourist sites than for meetings at Danish tourist sites.⁴⁹

Sweden limited deductions by employers of premiums on employee pension insurance to insurance purchased from Swedish companies.⁵⁰

44. Case 120/78, 1979 E.C.R. 649.

45. See also Case 8/74, *Procureur du Roi v. Dassonville*, 1974 E.C.R. 837 (holding that Belgium could not exclude Scotch whisky already in circulation in France on the ground that the French exporter did not have a U.K. certificate of authenticity that would be required for direct importation into Belgium from the United Kingdom).

46. Case 18/84, 1985 E.C.R. 1339.

47. Case C-118/96, *Safir v. Skattemyndigheten i Dalarnas Län*, 1998 E.C.R. I-1897. The court rejected the argument that the tax was not discriminatory because Swedish insurance companies were subject to Swedish taxation, while foreign companies were not.

48. Case C-294/97, *Eurowings Luftverkehrs AG v. Finanzamt Dortmund-Unna*, 1999 E.C.R. I-7447. The court rejected the argument that the provision was not discriminatory because German lessors would be subject to taxation in Germany.

49. Case C-55/98, *Skatteministeriet v. Vestergaard*, 1999 E.C.R. I-7641.

50. Case C-422/01, *Försäkringsaktiebolaget Skandia (publ) v. Riksskatteverket*, 2003 E.C.R. I-6817.

Finland taxed residents on their winnings from foreign lotteries, but not from Finnish lotteries.⁵¹

ECJ decisions sometimes fall into more than one category of discrimination in our framework because the three categories can overlap. For example, the Danish case in the list above involved a Danish entity that organized a foreign business meeting for Danish clients,⁵² so the decision involved both a foreign product and foreign production. We do not separately analyze such overlapping cases because our goal is simply to show that the ECJ jurisprudence operates on all three dimensions of discrimination.

In addition to restricting discrimination against products imported from other member states, the ECJ has long constrained heavier taxation by source countries of enterprises from other member states. An early example of this second category of discrimination arose because dividends paid by French corporations to French insurance companies benefited from a tax credit, whereas such dividends paid to non-French insurance companies operating in France did not.⁵³ The court reasoned that if France treated foreign companies operating in France on the same footing as French companies for the purpose of taxing their profits, it could not treat them differently with regard to a related tax advantage without giving rise to discrimination.

An important recent example of potential discrimination against foreign producers is found in *Lankhorst-Hohorst GmbH v. Finanzamt Steinfurt*.⁵⁴ In that

51. Case C-42/02, *In re Lindman*, 2003 E.C.R. I-13,519. The court rejected the argument that the provision was not discriminatory because the organizers of Finnish lotteries could be subject to Finnish taxation. In addition to the cases discussed in the text, the ECJ has decided a number of other cases involving imported products and services. See, e.g., Case C-334/02, *Comm'n v. France*, 2004 E.C.R. I-2229 (rejecting a policy allowing French holders of French debt to elect a lower tax rate, whereas French holders of foreign debt could not); Case C-17/00, *De Coster v. Collège des bourgmestres et échevins de Watermael-Boitsfort*, 2001 E.C.R. I-9445 (invalidating Belgium's tax on satellite dishes when Belgian broadcasters, but not foreign broadcasters, had the option of using untaxed cable systems as an alternative); Case C-478/98, *Comm'n v. Belgium*, 2000 E.C.R. I-7587 (invalidating Belgium's exclusion of noninstitutional Belgian investors from a Eurobond issuance by the Belgian government in German marks through German financial institutions); C-439/97, *Sandoz GmbH v. Finanzlandesdirektion für Wien, Niederösterreich und Burgenland*, 1999 E.C.R. I-7041 (invalidating an Austrian stamp tax due on foreign borrowing when there was no written loan agreement and when no such tax would be due on borrowing from an Austrian lender).
52. *Skatteministeriet*, 1999 E.C.R. at I-7644.
53. Case 270/83, *Comm'n v. France*, 1986 E.C.R. 273. These shareholder credits were part of an imputation system eliminating the double taxation of corporate income. We discuss such systems in Section II.A.
54. Case C-324/00, 2002 E.C.R. I-11,779.

case, the ECJ considered a law under which German subsidiaries of non-German parent companies were denied deductions for interest paid to the foreign parent company when the subsidiary had a high debt-to-equity ratio, although such deductions were allowed for payments by German subsidiaries to German parent companies. The general purpose of such thin capitalization provisions, which are common in developed countries,⁵⁵ 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. In spite of that purpose, the ECJ held that applying such provisions to foreign, but not domestic, parent companies violated the treaty freedoms. Other examples of source-country discrimination against incoming investment invalidated by the ECJ include:

The United Kingdom paid interest on U.K. tax refunds to U.K. companies but not on refunds to U.K. branches of non-U.K. companies.⁵⁶

Greece subjected Greek branches of foreign banks to a higher rate of tax than Greek banks.⁵⁷

The United Kingdom imposed an “advance corporate tax” on dividends of U.K. subsidiaries of non-U.K. parent companies but not on U.K. subsidiaries of U.K. parent companies.⁵⁸

55. *E.g.*, I.R.C. § 163(j) (West 2002 & Supp. 2005).

56. Case C-330/91, *The Queen v. Inland Revenue Comm'rs*, 1993 E.C.R. I-4017.

57. Case C-311/97, *Royal Bank of Scotland plc v. Greece*, 1999 E.C.R. I-2651.

58. Joined Cases C-397 & C-410/98, *Metallgesellschaft Ltd v. Comm'rs of Inland Revenue*, 2001 E.C.R. I-1727. The “advance corporate tax” was a component of an imputation system intended to reduce double taxation of corporate income. We discuss such systems in Subsection II.A.1. For additional cases involving source-country discrimination against incoming investment, see, for example, Case C-253/03, *CLT-UFA SA v. Finanzamt Köln-West* (Feb. 23, 2006), <http://www.curia.eu.int/en/content/juris/index.htm> (search for “Case C-253/03”), which invalidated a higher German tax on a branch of a foreign company than on a German subsidiary of a foreign company; Case C-307/97, *Compagnie de Saint-Gobain, Zweigniederlassung Deutschland v. Finanzamt Aachen-Innenstadt*, 1999 E.C.R. I-6161, which struck down tax relief for foreign investments that was available for German companies, but not for such investments by foreign companies operating in Germany; and Case C-1/93, *Halliburton Servs. BV v. Staatssecretaris van Financiën*, 1994 E.C.R. I-1137, which invalidated a Dutch transfer tax exemption available only if both the transferor and transferee were Dutch companies.

As indicated in the previous Section, countries are generally free under the international trade and tax treaties to favor domestic production over foreign production by their own companies. The ECJ, on the other hand, has invalidated many provisions of this type, particularly in recent years. An important case in this category is *Marks & Spencer plc v. Halsey*,⁵⁹ which involved a British retailer whose Belgian, French, and German subsidiaries had suffered substantial losses and were eventually closed or sold. The key issue before the court was whether the United Kingdom had to allow Marks & Spencer to offset the foreign losses against its U.K. domestic taxable income. The litigation stimulated a great deal of interest and commentary in Europe because disallowance of losses of foreign subsidiaries is a common feature of member state tax systems, so the potential revenue loss was enormous.⁶⁰

Like many countries, the United Kingdom taxes U.K. corporations, including subsidiaries of U.K. parent companies, on domestic and foreign income (subject to a foreign tax credit). Foreign subsidiaries of U.K. companies are not generally subject to U.K. tax on their current income, but the U.K. parents are taxed on dividends received from foreign subsidiaries (also subject to a foreign tax credit). Under U.K. law, losses in domestic, but not foreign, subsidiaries can be used to offset income in U.K. parent companies. This system of “group relief” requires the subsidiary to “surrender” the loss to the parent, so it cannot be used twice.

Before *Marks & Spencer* was referred to the ECJ, two of Europe’s leading international tax specialists, sitting as special commissioners of the U.K. Department of Inland Revenue, decided in favor of the government.⁶¹ They held that the failure to extend loss offsets to foreign subsidiaries did not violate the EC Treaty because the income of foreign subsidiaries was not subject to U.K. taxation. Citing previous ECJ decisions, the commissioners concluded that the U.K. taxation of dividends to parent companies was not germane because parent and subsidiary were different taxpayers.

The ECJ Advocate General subsequently recommended that the U.K. provisions be struck down, interpreting the treaty freedoms to require no less

59. Case C-446/03 (Dec. 13, 2005), <http://www.curia.eu.int/en/content/juris/index.htm> (search for “Case C-446/03”).

60. E.g., Cordewener et al., *supra* note 42; Gerard T.K. Meussen, *Cross-Border Loss Relief in the European Union Following the Advocate General’s Opinion in the Marks & Spencer Case*, 45 EUR. TAX’N 282 (2005); Lee A. Sheppard, *Dowdy Retailer Set To Destroy European Corporate Tax*, 104 TAX NOTES 16 (2004); Christian Wimpissinger, *Beyond Marks & Spencer: Cross-Border Losses and EC Law*, 38 TAX NOTES INT’L 923 (2005).

61. *Marks & Spencer plc v. Halsey*, No. SPC 00352 (Dec. 17, 2002) (opinion of Special Comm’rs Jones & Gammie) (on file with authors).

favorable treatment for transnational than purely national investment situations.⁶² From this perspective, he concluded that investment abroad was disadvantaged relative to investment at home under U.K. law. While the U.K. special commissioners focused on the symmetrical treatment of foreign income and losses, the Advocate General focused on the fact that a U.K. parent and a domestic subsidiary could not both use a loss surrendered by the latter. Accordingly, the Advocate General concluded that the United Kingdom could not prevent the use by a U.K. parent company of the loss of a foreign subsidiary unless the latter was able to deduct or carry forward the loss in the source country.

The ECJ reached the same result as the Advocate General, although without articulating any broad principles of interpretation.⁶³ In the court's view, the U.K. system of group relief was simply a tax advantage that could not be limited to domestic subsidiaries.⁶⁴ It is easy to formulate the outcome as necessary to avoid discrimination against foreign production: Losses of domestic subsidiaries are available to offset income of U.K. parent companies (on the condition that the subsidiaries cannot use the losses); therefore losses

62. Case C-446/03, *Marks & Spencer plc v. Halsey* (Apr. 7, 2005) (opinion of Advocate General Maduro), <http://www.curia.eu.int/en/content/juris/index.htm> (search for "Case C-446/03"). As indicated above, see *supra* text accompanying note 43, Advocate General Maduro suggested that Treaty freedoms should be considered related means to prevent measures promoting internal trade to the detriment of intracommunity trade. *Id.* ¶¶ 37, 39-40.

63. The court stated its holding ("ruling" in ECJ parlance) as follows:

As Community law now stands, Articles 43 EC and 48 EC do not preclude provisions of a Member State which generally prevent a resident parent company from deducting from its taxable profits losses incurred in another Member State by a subsidiary established in that Member State although they allow it to deduct losses incurred by a resident subsidiary. However, it is contrary to Articles 43 EC and 48 EC to prevent the resident parent company from doing so where 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 and where there are no possibilities for those 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.

Marks & Spencer, ¶ 61 (Dec. 13, 2005). The United Kingdom has announced plans to modify its legislation to allow foreign losses falling within the second sentence of the court's ruling, but only if the losses are not part of a tax-motivated transaction. Press Release, HM Revenue & Customs, Changes to Company Tax Relief Following European Court of Justice (ECJ) Judgment (Feb. 20, 2006), available at <http://www.gnn.gov.uk/Content/Detail.asp?ReleaseID=188162&NewsAreaID=2>.

64. *Marks & Spencer*, ¶¶ 32-34 (Dec. 13, 2005).

of foreign subsidiaries must be available to offset the income of such parent companies (on the same condition). It is also easy to see how this result applies to Marks & Spencer, because its subsidiaries had been liquidated or sold. On the other hand, the court failed to provide any helpful guidance on the meaning of the condition under other circumstances, particularly when the definition of losses and the provisions for deductibility differ across member states. We will not be surprised to see the question of foreign loss offsets return to the ECJ.

The foreign investment in *Marks & Spencer* through a foreign subsidiary is commonly called direct investment. Another form of foreign investment occurs when individuals in one country purchase shares in foreign companies. This is known as portfolio investment. The ECJ has invalidated a number of residence-country tax provisions that restrict outgoing investment in both categories, including:

The United Kingdom did not allow U.K. holding companies to consolidate losses unless their business consisted wholly or mainly of holding shares in U.K. subsidiaries.⁶⁵

France permitted companies selling medical products to deduct research and development costs, but only if those costs were incurred in France.⁶⁶

The Netherlands taxed dividends that Dutch shareholders received from foreign companies but not dividends they received from Dutch companies.⁶⁷

Austria taxed dividends that Austrian shareholders received from foreign companies at a higher rate than dividends they received from Austrian companies.⁶⁸

Finland provided shareholder credits for corporate taxes to Finnish holders of shares in domestic, but not foreign, corporations.⁶⁹

65. Case C-264/96, *Imperial Chemical Industries plc v. Colmer*, 1998 E.C.R. I-4695.

66. Case C-254/97, *Société Baxter v. Premier Ministre*, 1999 E.C.R. I-4809.

67. Case C-35/98, *Staatssecretaris van Financiën v. B.G.M. Verkooijen*, 2000 E.C.R. I-4071 (deciding the case on the basis of a Commission directive implementing Treaty freedoms).

68. Case C-315/02, *Lenz v. Finanzlandesdirektion für Tirol*, 2004 E.C.R. I-7063.

69. Case C-319/02, *In re Manninen*, 2004 E.C.R. I-7477. Additional cases involve discrimination against outgoing investment or transfers. See, e.g., Case C-471/04, *Finanzamt Offenbach am Main-Land v. Keller Holding GmbH* (Feb. 23, 2006), <http://www.curia.eu.int/en/content/juris/index.htm> (search for "Case C-471/04") (invalidating a German disallowance of

As we explain below, the last three of these decisions, which concern outgoing portfolio investment, helped demolish a widespread European system for eliminating or mitigating the double taxation of corporate income.

II. IMPLICATIONS OF THE ECJ DECISIONS

A. Legal Implications

It should be evident that the ECJ has adopted a much more robust concept of discrimination than that found in international tax and trade law, particularly with respect to outgoing investment. Indeed, a recent PricewaterhouseCoopers study concludes that the corporate tax systems of all twenty-five EU members contain provisions that violate the court's jurisprudence.⁷⁰

financing costs for foreign, but not domestic, second-tier subsidiaries); Case C-268/03, *De Baeck v. Belgium*, 2004 E.C.R. I-5961 (invalidating a Belgian capital gains tax on shares transferred to foreign, but not domestic, buyers); Case C-9/02, *De Lasteyrie du Saillant v. Ministère de l'Économie, des Finances et de l'Industrie*, 2004 E.C.R. I-2409 (invalidating a French tax on the transfer of stock abroad); Case C-168/01, *Bosal Holding BV v. Staatssecretaris van Financiën*, 2003 E.C.R. I-9409 (invalidating a Dutch deduction for financing costs for domestic subsidiaries, but not for foreign subsidiaries unless they produced income in Holland); Case C-436/00, *X v. Riksskatteverket*, 2002 E.C.R. I-10,829 (invalidating a provision under which transfer of shares to foreign companies or companies with foreign parents for less than market value was taxable to Swedish shareholders when the transfer to Swedish companies without foreign parents was not); Case C-141/99, *Algemene Maatschappij voor Investeren en Dienstverlening NV (AMID) v. Belgium*, 2000 E.C.R. I-11,619 (holding that Belgian operating losses could not be carried forward against Belgian income if those losses could have been offset against income of a foreign affiliate exempt under a tax treaty); Case C-251/98, *Baars v. Inspecteur der Belastingdienst Particulieren/Ondernemingen Gorinchem*, 2000 E.C.R. I-2787 (invalidating a Dutch exemption from wealth tax for shares in domestic, but not foreign, companies); Case C-200/98, *X AB v. Riksskatteverket*, 1999 E.C.R. I-8261 (invalidating a provision granting Swedish tax relief for transfers within corporate groups but not for transfer to a Swedish subsidiary partially owned by a controlled foreign company).

70. Press Release, PricewaterhouseCoopers LLP, PricewaterhouseCoopers Study Shows All 25 EU Countries' Tax Systems To Be in Breach of EU Law (Oct. 14, 2004), available at <http://www.ukmediacentre.pwc.com/content/detail.asp?ReleaseID=1026&NewsAreaID=2>. For an earlier analysis, see *European Union: Fundamental Freedoms for Citizens, Fundamental Restrictions on National Tax Law*, 40 EUR. TAX'N (SPECIAL ISSUE) 3 (2000) (identifying provisions of national law that are arguably contrary to ECJ jurisprudence).

Member state victories in corporate tax cases have been rare.⁷¹ In principle, provisions that violate EC Treaty freedoms can be justified on certain grounds, such as the internal consistency of the member state's tax system (usually styled "cohesion" or "coherence" in ECJ opinions) and the prevention of tax avoidance. In the past, however, the court has rarely upheld provisions on these grounds, often stating that less intrusive means to such ends should be available (the principle of proportionality).⁷² The ECJ also regularly rejects arguments by member states based on loss of revenue and erosion of the tax base,⁷³ although at least one recent advocate general's opinion suggests that financial consequences may be relevant.⁷⁴

A robust prohibition of discrimination against commerce among member states may sound innocuous or even benign, given the goal of creating a single internal market in the EU. However, a requirement of nondiscrimination is too unidimensional an approach for many issues of income tax design. The ECJ decisions to date suggest potentially staggering constraints on countries' freedom to resolve what strike us as quintessentially legislative issues—constraints that are fundamentally inconsistent with the fiscal autonomy retained by the member states in their right to veto EU taxing provisions. In this Section, we explore the legal implications of the ECJ jurisprudence both retrospectively and prospectively. We begin by showing how the court undermined a longstanding system for avoiding double taxation of corporate income in many EU countries. We then speculate on whether EU member states are still free to encourage domestic investment with tax incentives and to eliminate international double taxation with foreign tax credits.

71. One exception is Case 81/87, *The Queen v. HM Treasury*, 1988 E.C.R. 5483 (upholding the U.K. requirement of government consent if a U.K. company moved its business headquarters abroad, removing it from U.K. tax jurisdiction).

72. See MASON, *supra* note 5, at 93-114.

73. *Id.* at 110.

74. Case C-475/03, *Banca Popolare di Cremona v. Agenzia Entrate Ufficio Cremona* (Mar. 17, 2005) (opinion of Advocate General Jacobs), <http://www.curia.eu.int/en/content/juris/index.htm> (search for "Case C-475/03") (considering whether a regional tax on production levied in Italy is compatible with the prohibition of national turnover taxes other than a value-added tax); see also Michael Lang, *The Marks & Spencer Case—The Open Issues Following the ECJ's Final Word*, 46 EUR. TAX'N 54, 67 (2006) (arguing that the ECJ's decision in *Marks & Spencer* might have been motivated by revenue considerations).

1. *The Demise of Imputation*

Until recently, many countries in the EU avoided double taxation of corporate income (once to the corporation and again to shareholders on receipt of a dividend) by providing a full or partial shareholder credit for corporate taxes previously paid with respect to income distributed as a dividend.⁷⁵ Full implementation of such a credit would result in corporate income ultimately being taxed only once, at the shareholder's tax rate, so the income is said to be imputed to shareholders.⁷⁶

The other major policy option for integrating corporate and shareholder taxes is a full or partial shareholder exclusion of dividends.⁷⁷ Full implementation of an exclusion would result in corporate income ultimately

75. For further discussion of the issues involved in designing an integrated tax system, see U.S. DEP'T OF THE TREASURY, *INTEGRATION OF THE INDIVIDUAL AND CORPORATE TAX SYSTEMS: TAXING BUSINESS INCOME ONCE* (1992); ALVIN C. WARREN, JR., *AM. LAW INST., INTEGRATION OF THE INDIVIDUAL AND CORPORATE INCOME TAXES, REPORTER'S STUDY OF CORPORATE TAX INTEGRATION* (1993); and Michael J. Graetz & Alvin C. Warren, Jr., *Integration of Corporate and Individual Income Taxes: An Introduction*, 84 *TAX NOTES* 1767 (1999). The foregoing are collected in *INTEGRATION OF THE U.S. CORPORATE AND INDIVIDUAL INCOME TAXES: THE TREASURY DEPARTMENT AND AMERICAN LAW INSTITUTE REPORTS* (Michael J. Graetz & Alvin C. Warren, Jr. eds., 1998) [hereinafter *TREASURY AND ALI INTEGRATION REPORTS*].

76. Consider a corporation that earns \$200, pays \$60 in corporate taxes at a rate of 30%, and distributes half of the remaining \$140 each to shareholders *A* and *B*, whose tax rates are 25% and 35%. As shown in the table below, full imputation converts the corporate tax into a withholding tax, with each shareholder ultimately receiving the same after-tax return he would have received if his share of the corporate income had been taxed at his individual tax rate:

SHAREHOLDERS	A(25%)	B(35%)
1. Shareholder cash dividend	\$70	\$70
2. Shareholder taxable income	\$100	\$100
3. Preliminary shareholder tax	\$25	\$35
4. Tax credit	(\$30)	(\$30)
5. Final shareholder tax (3-4)	(\$5)	\$5
6. Net shareholder cash (1-5)	\$75	\$65

To avoid confusion, it is worth noting that an imputation shareholder credit is entirely distinct from the foreign tax credit discussed above. The former is aimed at reducing double taxation of corporate income (often called economic double taxation) that can occur in a single country, whereas the latter is aimed at reducing international double taxation (that involves taxation by more than one country). The two forms of multiple taxation converge when a corporation is taxed in one country and its shareholders in another.

77. A third option, deduction of dividends, is usually rejected because it would automatically extend the benefits of integration to exempt and foreign shareholders. See *TREASURY AND ALI INTEGRATION REPORTS*, *supra* note 75, at 251-53, 641.

being taxed only once, at the corporate tax rate. Largely as a result of the ECJ tax decisions, the shareholder credit option has now been abandoned in the EU,⁷⁸ in some cases even before the ECJ had decided whether it violated the EC Treaty freedoms. In order to understand this development, we need to explain two potential complications of imputation systems.

First, untaxed corporate income complicates imputation because a shareholder credit assumes that the corporation has paid the taxes to be credited on receipt of a dividend. Rather than requiring every corporation to report to every shareholder the amount of a varying tax credit on every distribution, the European approach to imputation had been to provide a standard credit and require the corporation to pay a compensatory tax on distributions if previously paid corporate taxes were less than the total amount of credits available to shareholders.

Second, international income also complicates imputation for both incoming and outgoing investment.⁷⁹ The key issue regarding incoming investment is whether the shareholder credit should be available to foreign investors. A source country typically imposes only flat-rate “withholding taxes” on dividends to foreign shareholders, because it has no way of knowing the rest of the shareholder’s income situation. The traditional practice has been to reduce these withholding taxes to identical low levels in bilateral tax treaties. Corporate income would therefore be subject to primary taxation in the source country (due to the exemption or foreign tax credit in the residence country), while dividends then paid to the foreign investors would be subject to primary taxation in the residence country (due to reduction of withholding taxes in the source country). In this situation, imputation would achieve integration for domestic investors, while leaving for treaty negotiation the question of whether shareholder credits would be extended to foreign investors. Countries have differed in their willingness to enter into treaties that extend credits to foreign shareholders. The most common decision—not to extend such credits to foreign investors—creates the possibility of source-country favoritism of domestic investors, because the corporate tax on domestic income would be integrated when distributed to domestic, but not foreign, shareholders.

78. See, e.g., Richard J. Vann, *General Report*, 88A CAHIERS DE DROIT FISCAL INTERNATIONAL [STUD. INT’L FISCAL L.] 21 (2003).

79. See PETER A. HARRIS, *CORPORATE/SHAREHOLDER INCOME TAXATION AND ALLOCATING TAXING RIGHTS BETWEEN COUNTRIES* (1996); TREASURY AND ALI INTEGRATION REPORTS, *supra* note 75, at 12-14, 183-98, 735-63; Hugh J. Ault, *Corporate Integration, Tax Treaties and the Division of the International Tax Base: Principles and Practices*, 47 TAX L. REV. 565 (1992); Hugh J. Ault, *International Issues in Corporate Tax Integration*, 10 LAW & POL’Y INT’L BUS. 461 (1978).

Regarding outgoing investment, the key issue is whether foreign taxes paid on corporate income earned abroad should reduce shareholder taxes when that income is distributed as a dividend. The tendency has been to ignore corporate-level foreign taxes when computing individual shareholder taxes on dividends out of foreign income. Distribution of foreign income to shareholders could therefore trigger a compensatory tax, leading to the possibility of residence-country bias against investment abroad. Domestic corporate income is taxed only once by the residence country when distributed to domestic shareholders under full imputation. Foreign corporate income is taxed in the source country and typically benefits from either an exemption or a foreign tax credit in the residence country, but such income typically is taxed again when distributed to shareholders as a dividend.

The potential for favoring domestic investors and domestic investment under imputation has long been known, and various solutions have been proposed in Commission studies over the years.⁸⁰ The unanimity requirement, however, always precluded adoption of any particular solution, and member states began to fear that their imputation systems would be found by the ECJ to violate the EC Treaty freedoms. After the court held in 2000 that an exemption for domestic dividends had to be extended to dividends from other member states,⁸¹ the Commission forcefully argued that imputation also

80. See *Commission Staff Working Paper, Company Taxation in the Internal Market*, SEC (2001) 1681 (Oct. 23, 2001), available at http://europa.eu.int/comm/taxation_customs/resources/documents/company_tax_study_en.pdf [hereinafter *Working Paper on Company Taxation*] (finding rate differences the most important corporate tax distortion within the EU, but recommending harmonization of the tax base); Comm'n of the Eur. Communities, *Report of the Committee of Independent Experts on Company Taxation* (Ruding Committee Report) (Mar. 1992) (recommending staged steps to reduce corporate tax distortions, including a minimum base and rate, as well as extension of imputation credits to foreign income); *Commission Proposal for a Council Directive Concerning the Harmonization of Systems of Company Taxation and of Withholding Taxes on Dividends*, 1975 O.J. (C 253) 2 (recommending a common imputation system); A.J. van den Tempel, *Corporation Tax and Individual Income Tax in the European Communities* (EEC Comm'n, Approximation of Legislation Series No. 15, 1970) [hereinafter *van den Tempel Report*] (recommending a common system of separate corporate and individual income taxation); EEC Comm'n, *The Development of a European Capital Market* (Segré Report) (Nov. 1966), available at http://europa.eu.int/comm/economy_finance/emu_history/documentation/chapter1/19661130en382develeurocapitm_a.pdf (recommending imputation credits be extended to foreign income or foreign shareholders); EEC Comm'n, Fiscal and Fin. Comm., *Report on Tax Harmonization in the Common Market* (Neumark Report) (July 8, 1962), reprinted in *TAX HARMONIZATION IN THE COMMON MARKET* 7 (Commerce Clearing House, Inc. ed. & trans. 1963) (recommending a common system of split-rate corporate taxation under which preferential rates would apply to distributed earnings).

81. Case C-35/98, *Staatssecretaris van Financiën v. B.G.M. Verkooijen*, 2000 E.C.R. I-4071.

violated the EC Treaty freedoms.⁸² Late in 2004, the ECJ eventually did strike down the Finnish imputation system because it failed to provide tax credits to Finnish shareholders for corporate taxes paid to other member states by companies established in those member states.⁸³

The major European countries had, however, already begun abandoning their imputation systems in anticipation of a negative decision by the ECJ. Legislation effective in 2001 replaced the German imputation system with a shareholder exclusion for half of dividends received, whether from within Germany or from abroad, including from countries outside the EU. While some policy analysts had argued for this change on the basis of the developing ECJ jurisprudence, others had opposed the resulting partial double taxation of corporate income as economically harmful to Germany.⁸⁴ The United Kingdom had already eliminated much of its imputation system in legislation effective in 1999, which retained the form of a shareholder tax credit in order not to violate certain provisions of the U.K.-U.S. tax treaty.⁸⁵ Those treaty provisions have since been eliminated, so some observers now anticipate a more transparent version of the U.K. legislation that will eliminate the shareholder credit even as a matter of form.⁸⁶ Finally, France and Italy both adopted legislation in 2003 that replaced their imputation systems with a partial shareholder exclusion for dividends.⁸⁷ As of this writing, only a few of

82. *Communication from the Commission to the Council, the European Parliament and the European Economic and Social Committee, Dividend Taxation of Individuals in the Internal Market*, COM (2003) 810 final (Dec. 19, 2003).
83. Case C-319/02, *In re Manninen*, 2004 E.C.R. I-7477; see also Case E-1/04, *Fokus Bank ASA v. Norway*, [2005] 1 C.M.L.R. 10 (Eur. Free Trade Area Ct. Nov. 23, 2004), available at http://www.dinesider.no/customer/770660/archive/files/Decided%20Cases/2004/e_1_04decision-e.pdf (holding that Norway's failure to grant imputation credits to German and U.K. shareholders of a Norwegian company violated the free movement of capital provisions of the European Economic Area Agreement, which extends certain aspects of the EU internal market to Iceland, Liechtenstein, and Norway).
84. See Klaus Eicker, *EC Tax Scene: Germany Introduces a 'Classical' System of Corporate Taxation in Order To Meet European Requirements*, 28 *INTERTAX* 453 (2000); Stephan Eilers & Holger Häuselmann, *German Tax Reform 2001*, *DERIVATIVES REP.*, Oct. 2000, at 1; Dieter Endres & Andreas Oestreicher, *2001 Tax Reform in Germany—Planning for a New Era*, 28 *INTERTAX* 408 (2000); Klaus Sieker, *The German Reduction Tax Act 2001*, 30 *TAX MGMT. INT'L J.* 115 (2001).
85. See Malcolm Gammie, *UK Imputation, Past, Present and Future*, 52 *BULL. INT'L FISCAL DOCUMENTATION* 429 (1998).
86. See Vann, *supra* note 78, at 50.
87. Eric Berengier, *France Amends Treatment of Dividend Distributions*, 38 *TAX NOTES INT'L* 467 (2005); Gianluca Queiroli, *Italy's Dividends Tax Treatment: A Chance of Harmonization*, 35 *TAX NOTES INT'L* 535 (2004).

the EU member states still have imputation systems; most have adopted some form of dividend exclusion.⁸⁸

The demise of the European imputation systems would have been remarkable enough if it had followed an unequivocal ECJ decision reflecting agreement that discrimination against international commerce was an inherent feature of such systems. However, many member states repealed longstanding legislation even before a final ECJ decision. Moreover, the Advocate General eventually indicated in *In re Manninen* that imputation might well conform with the treaty freedoms if certain modifications were made.⁸⁹

We do not argue here that shareholder credits are necessarily superior to shareholder exclusions as a means of eliminating the double taxation of corporate income.⁹⁰ The choice turns largely on the tradeoff between progressivity and simplicity. A credit would apply the shareholder's marginal tax rate to corporate-source income, while an exclusion would avoid many of the complexities of imputation. That choice seems to us quintessentially legislative. Our point is that making nondiscrimination the sole criterion for the choice necessarily suppresses considerations of efficiency, fairness, and administrability that should inform difficult tax policy decisions. Nor do we deny the possibility that some countries might have used the specter of ECJ action as cover for repealing imputation for other reasons; even that possibility would demonstrate the reach of the court's jurisprudence.

2. *The Future of Tax Incentives and International Double Taxation*

Is the demise of imputation the harbinger of other profound consequences for member state business tax laws? We address this question by speculating on the potential effects of the ECJ decisions on two other typical features of corporate taxation: stimulation of domestic investment and elimination of international double taxation.

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88. Austria, Malta, Spain, and the United Kingdom retain some version of imputation. EUROPEAN TAX HANDBOOK 2005, at 56, 464, 613, 725 (Juhani Kesti ed., 16th ed. 2005). In 2003, the United States extended the preferential tax rate on capital gains to dividends, which has the same effect as a partial exclusion. See I.R.C. § 1(h)(11) (West Supp. 2005).
89. Case C-319/02, *In re Manninen*, 2004 E.C.R. I-7477, ¶ 80 (Mar. 18, 2004) (opinion of Advocate General Kokott). For a recent discussion of methods to reduce bias against international investment in the context of the Australian imputation system, see C. John Taylor, *Alternative Treatments for Foreign Source Income in Australia's Dividend Imputation System*, 20 AUSTL. TAX F. 189 (2005).
90. In previous work relating to the U.S. corporate tax, one of us has favored credits, while the other has favored exclusions. See TREASURY AND ALI INTEGRATION REPORTS, *supra* note 75, at 7-8, 77-96, 637-90.

Inspired by the success of Silicon Valley, France recently announced the creation of sixty-seven *pôles de compétitivité*, regional sites where public and private research efforts would be combined to achieve excellence in a particular business domain.⁹¹ The French government promised support of at least €1.5 billion over three years, including reductions in corporate taxation and social security contributions for participants.

Are the contemplated tax reductions for these sites, all of which are in France, consistent with the ECJ case law? In addition to the decisions noted above, consider that the court recently struck down French legislation limiting a research tax credit to research conducted in France.⁹² As for the Commission, it has indicated that Europe needs additional spending for research,⁹³ but it has also formally requested that Spain modify its tax deduction for research and development, because research outside Spain is subject to limitations that do not apply to research done in Spain.⁹⁴ (Such formal requests are typically issued prior to instituting proceedings before the ECJ.) The strength of the Commission's negative view regarding tax benefits that are limited to a member state's territory is perhaps best illustrated by a noncorporate case it has filed in the ECJ seeking to invalidate a German income tax deduction for certain school expenses because the deduction was available only for schools in Germany.⁹⁵ The Commission reasoned that this restriction placed the

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91. Sophie Fay & François Grosrichard, *67 pôles de compétitivité pour dessiner une nouvelle France industrielle*, LE MONDE, July 13, 2005, at 8.
92. Case C-39/04, *Laboratoires Fournier SA v. Direction des vérifications nationales et internationales*, 2005 E.C.R. I-2057; *see also* Case C-242/03, *Ministre des Finances v. Weidert*, 2004 E.C.R. I-7379 (invalidating a Luxembourg tax deduction for the foundation or expansion of domestic, but not foreign, corporations).
93. Press Release, European Comm'n, *Why Europe Needs Research Spending* (June 9, 2005), available at <http://europa.eu.int/rapid/pressReleasesAction.do?reference=MEMO/05/199>; *see also* László Kovács, European Comm'r for Taxation and Customs, *EU Tax Policy and Its Implications for Ireland*, Speech to European Movement Ireland 12 (Feb. 24, 2006), available at http://europa.eu.int/comm/commission_barroso/kovacs/speeches/speech_dublin.pdf ("The Commission will issue a communication . . . proposing a common framework relating to R&D tax incentives [that] will set out the constraints of Community law and identify best practices.").
94. Press Release, European Comm'n, *Direct Taxation: Commission Requests Spain To Amend Laws Incompatible with the EC Treaty* (July 14, 2005), available at <http://europa.eu.int/rapid/pressReleasesAction.do?reference=IP/05/933>.
95. Press Release, European Comm'n, *Commission Decides To Refer Germany to Court Concerning Tax Deductions for School Fees* (July 15, 2005), available at <http://europa.eu.int/rapid/pressReleasesAction.do?reference=IP/05/946>; *see also* Press Release, European Comm'n, *Commission Refers Sweden to Court over Discriminatory Rules on Capital Gains Tax Relief on Home Sales* (Dec. 16, 2005), available at <http://europa.eu.int/rapid/pressReleasesAction.do?reference=IP/05/1621> (concluding that

provision of services by foreign schools at a disadvantage, making parents who would like their children to be educated in another member state worse off.

The Commission's position with respect to tax incentives for economic development is complicated by its role in enforcing treaty provisions that prohibit state aid to private enterprise that is incompatible with a single European market, while recognizing that some regional aid is appropriate.⁹⁶ Exercise of the Commission's discretion to reconcile these positions is, of course, subject to the ECJ's interpretation of the treaty freedoms.⁹⁷ With respect to taxation, the Commission has drawn a highly problematic distinction between provisions that are generally applicable and those that are exceptions, with only the latter constituting prohibited state aid.⁹⁸ Two recent examples of the Commission's use of state aid authority to invalidate tax incentives are its current investigation of Luxembourg's exemption for finance and holding companies (a benefit in effect since 1929) and its decision to condition preliminary approval of the *pôles de compétitivité* on an undertaking by France that corporate tax reductions would not exceed a de minimis amount (€100,000 per taxpayer per year).⁹⁹

the deferral of gain on the sale of a home violated the treaty freedoms because it was conditioned on the purchase of another home in Sweden).

96. EC Treaty art. 87; *see also* RAYMOND H.C. LUJA, *ASSESSMENT AND RECOVERY OF TAX INCENTIVES IN THE EC AND THE WTO* 77-80 (2003).
97. *See, e.g.*, Case C-156/98, *Germany v. Comm'n*, 2000 E.C.R. I-6857 (sustaining the Commission's rejection of a post-unification regional tax concession in certain former territories of East Germany on the ground that the state aid violated the freedom of establishment because the aid was limited to taxpayers headquartered in the region).
98. *Commission Notice on the Application of the State Aid Rules to Measures Relating to Direct Business Taxation*, 1998 O.J. (C 384) 3, ¶ 13 (providing examples of general provisions including tax rates, measures to prevent double taxation or tax avoidance, and measures pursuing general economic policy objectives such as research and development). The distinction between general provisions and exceptions is based on language in Article 87 of the EC Treaty that prohibits state aid "favouring certain undertakings or the production of certain goods." *See* Wolfgang Schön, *Taxation and State Aid Law in the European Union*, 36 COMMON MKT. L. REV. 911, 916-17 (1999) (comparing the scope of the four freedoms with that of the state-aid provisions). This distinction between general provisions and exceptions also is typically used to construct "tax expenditure" budgets, which, although published by many countries, remain controversial. *See, e.g.*, MICHAEL J. GRAETZ & DEBORAH H. SCHENK, *FEDERAL INCOME TAXATION: PRINCIPLES AND POLICIES* 41-56 (5th ed. 2005).
99. Press Release, European Comm'n, *State Aid: Commission Opens Formal Investigation into Luxembourg's 1929 Tax-Exempt Holdings* (Feb. 8, 2006), *available at* <http://europa.eu.int/rapid/pressReleasesAction.do?reference=IP/06/132>; Letter from Neelie Kroes, European Comm'n, to Michel Barnier, Foreign Minister, France ¶¶ 14, 32 (Jan. 19, 2005), *available at* http://europa.eu.int/comm/secretariat_general/sgb/state_aids/comp-2004/n407-04.pdf (regarding the "[r]égime d'aide que la France envisage de mettre à exécution en faveur des projets

We offer no opinion on whether corporate tax incentives like those for the French *pôles de compétitivité* will eventually pass muster under either the state-aid provisions or the treaty freedoms, but we think it is fair to conclude that the tax advantages involved are fundamentally inconsistent with the logic of the ECJ decisions that have invalidated tax provisions favoring domestic production. Indeed, we believe that member states may eventually find that their freedom to use a variety of tax measures to stimulate domestic economic development has been severely constrained by that jurisprudence.

We indicated earlier that there are two standard residence-country methods for reducing international double taxation in national laws and the bilateral tax treaties: exemption of foreign income and a foreign tax credit. Just as the ECJ decisions undermined the shareholder credit option for reducing economic double taxation of corporate income, some leading European analysts now argue that those decisions will also eliminate the foreign tax credit option for reducing international double taxation. We consider an indirect and a direct version of this argument.

As indicated in our discussion of *Marks & Spencer*, residence countries that have elected the foreign tax credit option do not generally tax the income of foreign subsidiaries of domestic corporations until it is repatriated as a dividend to the parent company. This deferral feature of international taxation creates a possibility for tax avoidance because earnings can be left to compound abroad in a safe investment in a low- or zero-tax jurisdiction. In response, many countries have adopted “controlled foreign corporation” (CFC) provisions that mandate current taxation to parent companies of passive investment income earned by foreign subsidiaries.¹⁰⁰ Parent companies are not generally taxed on undistributed earnings of domestic subsidiaries, so the ECJ has been asked to invalidate CFC regimes because they apply only to foreign subsidiaries.¹⁰¹ Given the importance of these anti-avoidance provisions, the litigation has attracted widespread attention in Europe.¹⁰² If the CFC

de R&D dans les pôles de compétitivité”). The reductions for social security were approved because they fell within a limited exception for research and development.

100. *E.g.*, I.R.C. subpt. F (2000).

101. *E.g.*, Case C-196/04, *Cadbury Schweppes plc v. Comm’rs of Inland Revenue* (filed Apr. 29, 2004).

102. *See, e.g.*, CFC LEGISLATION, TAX TREATIES AND EC LAW (Michael Lang et al. eds., 2004); Birgitta Glad, *New Challenges to CFC Legislation in Norway—Developing EC Law*, 34 TAX NOTES INT’L 843 (2004); Marjaana Helminen, *Is There a Future for CFC-Regimes in the EU?*, 33 INTERTAX 117 (2005); Raymond H.C. Luja, *Tax Treaties and State Aid: Some Thoughts*, 44 EUR. TAX’N 234 (2004); Anders Rubinstein & Nikolaj Bjornholm, *News Analysis: Do the Lenz and Manninen Decisions Invalidate Danish Dividend and CFC Taxation?*, 36 TAX NOTES INT’L 286 (2004).

provisions are invalidated, some analysts argue that a foreign tax credit regime cannot be maintained because taxation of foreign income will be undermined by indefinite deferral.¹⁰³

A more direct form of the argument that the foreign tax credit method of reducing international double taxation is incompatible with the treaty freedoms is that it prevents a company resident in a high-tax country from benefiting from low taxes abroad.¹⁰⁴ This result is arguably the logical extension of the taxpayer's position in *Marks & Spencer* that a residence country cannot interfere with its companies' freedom to invest abroad.¹⁰⁵

There is, however, a fundamental problem with this argument. Consider commerce between a high-tax country (High) and a low-tax country (Low), each with one company that engages only in domestic commerce (H_d and L_d) and one company that engages only in commerce in the foreign country (H_f and L_f). As shown in the following matrix, nondiscrimination against foreign producers and foreign production (or capital import and capital export neutrality) in this simple example requires equivalent treatment of two companies in each country.

Figure 1.
EQUALITY OF TAX TREATMENT

	HIGH	LOW
Nondiscrimination Against Foreign Producers Requires	$H_d = L_f$	$L_d = H_f$
Nondiscrimination Against Foreign Production Requires	$H_d = H_f$	$L_d = L_f$

Given the overlap of source and residence jurisdiction, there are three companies potentially subject to taxation in each country: H_d , H_f , and L_f in High; L_d , L_f , and H_f in Low. As long as the two countries have different tax

103. E.g., Malcolm Gammie, *The Role of the European Court of Justice in the Development of Direct Taxation in the European Union*, 57 BULL. INT'L FISCAL DOCUMENTATION 86, 96 (2003).

104. See Peter J. Wattel, *Home Neutrality in an Internal Market*, 36 EUR. TAX'N 159 (1996) (arguing that the foreign tax credit is inconsistent with the idea of a common market). But see Case C-336/96, *Gilly v. Directeur des services fiscaux du Bas-Rhin*, 1998 E.C.R. I-2793 (refusing to invalidate a foreign tax credit limitation in a French-German tax treaty, as applied to labor income of frontier workers).

105. Lee A. Sheppard, *Responding to Marks & Spencer, or Not*, 104 TAX NOTES 1489, 1490-92 (2004) (reporting comments of Malcolm Gammie).

rates and bases, however, there is no way to achieve the specified equality of tax results. Consider the purely domestic companies H_d and L_d . As shown in the matrix, each must bear the same burden as L_f and H_f , which means that H_d and L_d must also bear the same tax burden, implying equal taxes in both High and Low, which is impossible.

This result is often expressed as the impossibility of implementing both capital export and import neutrality. One of us has previously made this point in terms of an irreconcilable conflict between three simple principles in the context of U.S. taxation of international transactions:

Principle 1: People should pay equal taxes on their income regardless of the country that is the source of that income. In particular, U.S. taxpayers should be treated equally regardless of the source of their income.

Principle 2: All investments in the United States should face the same burden regardless of whether a U.S. person or a foreign person makes the investment. In other words, U.S. and foreign-owned investments and businesses should be treated equally.

Principle 3: Sovereign countries should be free to set their own tax rates and to vary them as their domestic economic situations demand.¹⁰⁶

The essential difficulty is that the first two principles can hold simultaneously in two or more countries only if income is taxed identically (for example with the same rates and bases) in all such countries, which would rule out the third principle.

The conflicts underlying this impossibility result can produce irreconcilable claims of discrimination. Consider the case of H_f when High reduces international double taxation with a foreign tax credit. Unlike L_d , H_f will pay high taxes to High on its income in Low in order to achieve parity with H_d . As indicated above, H_f can describe its situation in terms of discrimination against international commerce by observing that it pays higher taxes than L_d solely because it is engaged in international commerce, whereas L_d is engaged in domestic commerce. On this view, the ECJ jurisprudence arguably requires High to replace its foreign tax credit with an exemption for foreign income in order to allow H_f to compete in Low on the same basis as L_d .¹⁰⁷ Carried to its logical extreme, this view of nondiscrimination would fully implement capital

^{106.} Graetz, *supra* note 34, at 272 n.36.

^{107.} See Wattel, *supra* note 104.

import neutrality by permitting only source-country taxation and eliminating residence-country jurisdiction over international income within the EU.¹⁰⁸

On the other hand, a conceptually parallel argument could be made on behalf of L_f , which, unlike L_d , is forced to pay high taxes to High in spite of its legal status as a Low company.¹⁰⁹ The idea here would be that High should not be able to interfere with a Low company's choice between domestic and foreign production by imposing high taxes on L_f when it engages in commerce outside its home country. On this view, companies would carry their home-country tax status and rates with them wherever they operated in the EU. Such a result would be consistent with ECJ decisions such as *Cassis de Dijon* requiring member states to accept products that satisfy a regulatory requirement in the exporting, but not the importing, member state.¹¹⁰ As for the Commission, this approach would be consistent with its proposed experiment in "home state taxation," which will permit some smaller companies to compute their EU taxable income under the tax laws of their country of origin beginning in 2007.¹¹¹ This approach would also be consistent with the Commission's proposal that a service provider generally be subject to regulation only in its

108. See, e.g., JIMÉNEZ, *supra* note 40, at 283 (concluding that only source-country taxation is consistent with the Treaty freedoms).

109. See Ian Roxan, *Assuring Real Freedom of Movement in EU Direct Taxation*, 63 MOD. L. REV. 831, 873 (2000) (suggesting that freedom of movement would, if anything, give preference to residence taxation); see also Cordewener et al., *supra* note 42, at 224-26 (suggesting that an exemption may be invalid because it would preclude the deduction of foreign losses); Howard M. Liebman & Olivier Rousselle, *Discriminatory Treatment of Dividends in the European Union: Is the End Near?*, 39 TAX NOTES INT'L 143 (2005) (explaining that a foreign tax credit is required for foreign withholding taxes to ensure that total taxes on incoming dividends are not higher than taxes on domestic dividends); Luja, *supra* note 102, at 235 (suggesting that the exemption may be invalid as a form of state aid if it is only made available under a tax treaty).

110. Case 120/78, *Rewe-Zentral AG v. Bundesmonopolverwaltung für Branntwein*, 1979 E.C.R. 649; see also Case C-250/95, *Futura Participations SA v. Administration des contributions*, 1997 E.C.R. I-2471 (citing *Cassis de Dijon* and holding that subjecting non-Luxembourg companies operating in Luxembourg to the same accounting requirements as Luxembourg companies was unduly burdensome and violated the Treaty freedoms); Case 8/74, *Procureur du Roi v. Dassonville*, 1974 E.C.R. 837.

111. *Commission Non-Paper to Informal Ecofin Council, Home State Taxation for Small and Medium-Sized Enterprises* (July 7, 2004), available at http://europa.eu.int/comm/taxation_customs/resources/documents/HST_Non-Paper_EN.pdf. As presently formulated, home state taxation would apply the home state tax base, but not its tax rate. A company's total EU income would be computed under home state legislation and then allocated to the member states on the basis of a formula, such as the company's payroll in each country, with the tax rate of each member state then applied to its allocation.

country of origin.¹¹² Carried to its logical extreme, this view of nondiscrimination would fully implement capital export neutrality by permitting only residence-country taxation and eliminating source-country jurisdiction in the EU.¹¹³

The problem with the argument that the foreign tax credit (and residence taxation) is discriminatory should now be apparent. There is simply no principled basis to prefer it over the opposite argument that exemption of foreign income (and source taxation) is discriminatory.¹¹⁴ Putting the point more generally, prohibiting discrimination based on destination is ultimately inconsistent with prohibiting discrimination based on origin. This indeterminacy confirms the limits of nondiscrimination as a tool for resolving basic issues of international taxation. The core tax policy issue here is the division of the tax base between source and residence countries, the resolution of which has depended more on compromise and practice than on any overarching principle.¹¹⁵ Regulating that division by reasoning from a principle of nondiscrimination ultimately produces an incoherent result.

So far, we have considered the logical implications of the ECJ's robust approach to nondiscrimination. Are there more modest approaches that the court might adopt that are less robust and not subject to our impossibility result? We will briefly consider two.

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112. See *Commission Proposal for a Directive of the European Parliament and of the Council on Services in the Internal Market*, COM (2004) 2 final/3 (Mar. 5, 2004). In spite of limitations on the country of origin principle, this proposal played a role in the campaign against the EU Constitution in France, where it was said that foreign service providers, symbolized by a Polish plumber, would work in France without having to comply with French regulations.
113. It has also been argued that exemption of foreign income may violate the provisions of the trade treaties that prohibit export subsidies. Reuven S. Avi-Yonah, *Treating Tax Issues Through Trade Regimes*, 26 *BROOK. J. INT'L L.* 1683, 1688 (2001).
114. Cf. Frans Vanistendael, *Marché interne et souveraineté fiscale*, in *REGARDS CRITIQUES ET PERSPECTIVES SUR LE DROIT ET LA FISCALITÉ* 255, 267 (Cyrille David ed., 2005) (arguing that the simultaneous existence of credit and exemption systems is incompatible with the single market mandated by the EC Treaty, but that the ECJ does not have the authority to choose between the two systems).
115. Since the 1920s, the standard compromise found in tax treaties with respect to corporate-source income is that residence countries defer to source countries with respect to corporate business income by means of a foreign tax credit or an exemption for foreign income, while source countries defer to residence countries with respect to shareholder dividend income by reducing or eliminating withholding taxes on dividends paid to foreign shareholders. See Michael J. Graetz & Michael M. O'Hear, *The "Original Intent" of U.S. International Taxation*, 46 *DUKE L.J.* 1021 (1997); see also Richard M. Bird & J. Scott Wilkie, *Source- vs. Residence-Based Taxation in the European Union: The Wrong Question?*, in *TAXING CAPITAL INCOME IN THE EUROPEAN UNION* 78 (Sjibren Cnossen ed., 2000) (arguing that source and residence are not particularly useful principles for assigning tax jurisdiction).

Our analysis, like the court's, has viewed the four freedoms as protecting taxpayers against higher taxation of transnational income than domestic income. A more limited approach would be to view the freedoms as only precluding a member state from taxing more heavily income that crosses its borders than income that does not.¹¹⁶ The key difference between these two approaches is that the latter would not take into account the tax situation in the other state. The most rigorous version of this approach would determine whether a taxing provision was neutral with respect to income and outgoing investment on the assumption that both countries had the same tax system and rates.¹¹⁷ In the conventional language of international taxation, member states would be required only to apply capital import neutrality to incoming investment and capital export neutrality to outgoing investment. Taxing foreign producers at a higher rate than domestic producers would be prohibited on this view, as would be an investment tax credit or other tax benefit available for domestic, but not foreign, production. However, distortions resulting from the interaction of national tax systems would not be eliminated, because one member state's action would be tested without regard to the tax situation in another member state.

While it might have been possible to argue for such an approach in the past, the ECJ decisions discussed above indicate that the court does not consider itself subject to any such limitations today, if it ever did.¹¹⁸ Consider

116. See Roxan, *supra* note 109 (proposing a cross-migration framework for identifying prohibited taxation of transborder income); Wolfgang Schön, *Tax Competition in Europe—the Legal Perspective*, 9 EC TAX REV. 90, 97-99 (2000) (arguing that the EC Treaty requires only that a country establish capital import neutrality within its borders and “not unreasonably hinder” exportation of capital, whether monetary, real, or human); Servaas van Thiel, *The Future of the Principle of Non-Discrimination in the EU: Towards a Right to Most-Favoured-Nation Treatment and a Prohibition of Double Burdens?* (Oct. 21, 2005) (unpublished manuscript, on file with authors).

117. van den Tempel Report, *supra* note 80, at 37; see also van Thiel, *supra* note 116, at 12 (“[T]he question of how to address discrimination, i.e. neutrality within one tax system, should be distinguished from the question how to address disparities between two tax systems . . .”). Professor van Thiel criticizes our conclusion that the logic of the ECJ's jurisprudence involves an impossible quest to eliminate discrimination based on both origin and destination of economic activity, because he sees the court's decisions as remaining “within one tax system.” As we indicate in the text, that view fails to account for much of the ECJ's jurisprudence.

118. In a recent opinion, Advocate General Geelhoed formulated the obligations of source and residence countries under the EC Treaty as nondiscrimination. Although he did not discuss the impossibility of fully eliminating discrimination based on both origin and destination, his interpretation of those obligations did lead him to reject or restrict some of the court's prior decisions finding treaty violations. Case C-374/04, *Test Claimants v. Comm'rs of*

again the *Marks & Spencer* decision, in which the court held that whether residence-country limitations on offsets for foreign losses were discriminatory depended on the availability of deductions for such losses in source countries.¹¹⁹ Or consider the *Manninen* decision, which struck down the Finnish imputation system because Finland did not provide tax credits to its residents for corporate taxes paid to a foreign country by a foreign corporation that then distributed dividends to Finnish shareholders. If the foreign tax were ignored, the Finnish legislation would not be discriminatory, because it would collect the same total amount of Finnish taxes (corporate and individual) on all corporate income distributed as dividends in Finland, whether the paying corporation was domestic or foreign. The successful claim of discrimination required the court to consider the taxes in both countries.¹²⁰ Such precedents have led some commentators to suggest that the ECJ decisions may now require member states to eliminate double taxation within the EU, a possibility that requires looking beyond the tax situation in a single country.¹²¹

A second approach related to nondiscrimination that would stop short of our impossibility result might be implied from the history of the double taxation and nondiscrimination provisions in the bilateral tax treaties developed under the aegis of the OECD.¹²² As discussed above, the tax treaties conceptualize the essential problem presented by outgoing investment as double taxation, not discrimination. The traditional solution has been for the

Inland Revenue (Feb. 23, 2006) (opinion of Advocate General Geelhoed), <http://www.curia.eu.int/en/content/juris/index.htm> (search for "Case C-374/04").

119. Case C-446/03, *Marks & Spencer plc v. Halsey* (Dec. 13, 2005), <http://www.curia.eu.int/en/content/juris/index.htm> (search for "Case C-446/03").
120. Case C-319/02, *In re Manninen*, 2004 E.C.R. I-7477. There are several other cases in which the ECJ has considered not only the tax law in the member state subject to litigation, but also the tax law in another member state. *E.g.*, Case C-403/03, *Schempp v. Finanzamt München V*, 2005 ECJ CELEX LEXIS 329 (July 12, 2005) (upholding German legislation that conditioned deductibility of maintenance payments to a former spouse on taxability in the spouse's country); Case C-376/03, *D. v. Inspecteur van de Belastingdienst*, 2005 ECJ CELEX LEXIS 349 (July 5, 2005) (upholding wealth tax differences due to differences in tax treaties); *cf.* Case C-336/96, *Gilly v. Directeur des services fiscaux du Bas-Rhin*, 1998 E.C.R. I-2793 (holding that a residence country's limitation of foreign tax credit to the domestic tax rate did not violate the EC Treaty in the context of labor income).
121. *See, e.g.*, Michael Lang, *Double Taxation and EC Law* (Oct. 21, 2005) (unpublished manuscript, on file with authors); van Thiel, *supra* note 116. Quite apart from the four freedoms, Article 293 of the EC Treaty provides that member states will eliminate double taxation. That Article was to be eliminated in the proposed constitution. For a critical view of the potential elimination, see Moris Lehner, *A Significant Omission in the Constitution for Europe?*, 2005 B.T.R. 337.
122. We are grateful to Hugh Ault for bringing this possibility to our attention.

residence country to cede primary jurisdiction over business income to the source country through either an exemption or a foreign tax credit. Source countries have, arguably in return, made two concessions: First, the source country cannot discriminate against investment from the residence country. Second, under the more recent OECD and EU attempts to limit tax competition,¹²³ the source country cannot favor incoming investment over domestic investment. The latter concession provides some discipline against source countries simply taxing incoming investment at lower rates, which could be considered inconsistent with the expectations of the residence countries when they ceded taxing jurisdiction. Similarly, one might argue that the foregoing two concessions by source countries are premised on the residence country not discouraging outgoing investment.

Given the starting point of double taxation solved by exemption and credit systems, one could then imagine a “nondiscrimination” approach in which source countries (as under current tax treaty practice) agree to apply the same rates to incoming investment that they apply to domestic investment, while residence countries (if discrimination against foreign production were prohibited) would apply the same rates to outgoing investment that they apply to domestic investment. Some might characterize this solution (like the EU state-aid rules) as prohibiting only special tax rates that favor or penalize transnational investment, while allowing countries full control over their general tax rates. As indicated above, we think such a distinction is problematic.¹²⁴

While we can imagine the OECD promoting this result,¹²⁵ there is little reason to think that the ECJ would consider the exemption and credit methods of avoiding double taxation as sacrosanct under the EC Treaty. Like the first limited approach discussed above, this solution would not in any event achieve locational neutrality, because there would still be different tax rates and different results under credit and exemption systems. Nations would retain some tax sovereignty because they could set rates, but they would no longer be

123. ORG. FOR ECON. COOPERATION AND DEV., CTR. FOR TAX POLICY & ADMIN., THE OECD'S PROJECT ON HARMFUL TAX PRACTICES: THE 2004 PROGRESS REPORT (2004), available at <http://www.oecd.org/dataoecd/60/33/30901115.pdf>; *Resolution of the Council and the Representatives of the Governments of the Member States, Meeting Within the Council of 1 December 1997 on a Code of Conduct for Business Taxation*, 1998 O.J. (C 2) 1 (Annex 1), available at http://europa.eu.int/comm/taxation_customs/resources/documents/COC_EN.pdf. Not all non-EU OECD countries have agreed to this constraint.

124. See *supra* text accompanying note 98.

125. The OECD is presently studying possible changes to the nondiscrimination article in its model tax treaty. See Bennett, *supra* note 30 (manuscript at 3 n.4, on file with authors).

able to use tax provisions (or presumably any other tool of public policy) to promote domestic investment. Even in the OECD context, it seems unlikely that countries such as the United States would be willing to abandon these tools.

Political compromise is another way to avoid the impossibility result, but that is not the institutional role of the court. Absent some broad legislative solution, which seems a long way off for Europe, the particular aspects of member states' tax laws that will be struck down will depend on the agenda of the ECJ. That agenda will in turn depend on which cases the Commission chooses to bring and which cases private parties consider worth the costs of litigation. The latter criterion suggests that the member states may well find themselves defending cases that are unwinnable and, at the same time, expensive to lose. Complete harmonization of member state tax bases and rates could eliminate the underlying conflicts, but such a resolution could come only from EU policymakers. Although the Commission is actively pursuing the possibility of base harmonization,¹²⁶ it currently opposes the policy of rate harmonization urged by some member states.¹²⁷ We will return to the possibility of base and rate harmonization below.

B. Fiscal Policy Implications

Not only does the ECJ's jurisprudence have troubling legal implications, it also raises a series of fiscal policy implications. One pattern emerging from the court's jurisprudence is that its decisions generally reduce taxes in the member states. Indeed, whenever the court decides a tax case brought by a private party (and referred to the ECJ by a national court), the best result a member state can achieve is to maintain the status quo. Private litigants simply will not pay the

126. *Communication from the Commission to the Council, the European Parliament and the Economic and Social Committee: Towards an Internal Market Without Tax Obstacles—A Strategy for Providing Companies with a Consolidated Corporate Tax Base for Their EU-Wide Activities*, COM (2001) 582 final (Oct. 23, 2001) [hereinafter *Communication on Consolidated Corporate Tax Base*]; *EU Summarizes November Meeting of Harmonized Tax Base Working Group*, WORLDWIDE TAX DAILY, Jan. 21, 2005, 2005 WTD 18-16 (LEXIS).

127. E.g., Johnathan Rickman & Charles Gnaedinger, *European Commission Rebuffs French-German Initiative To Harmonize Corporate Tax*, WORLDWIDE TAX DAILY, May 14, 2004, 2004 WTD 94-3 (LEXIS). There are undoubtedly some member states that are skeptical of the future steadfastness of the opposition to rate harmonization on the part of a Commission committed to reduction of economic distortions within the EU. See, e.g., *Working Paper on Company Taxation*, *supra* note 80 (finding that different national tax rates are the single most important difference between national and transnational investment, a conclusion that would be strengthened by the proposed harmonization of tax bases).

costs of litigating unless victory promises lower taxes. And while cases brought to the ECJ by the Commission might either raise or lower taxes, we believe that, to date at least, they have tended to reduce taxes.¹²⁸ The ECJ has been quite explicit in refusing to take the revenue costs to a member state into account in reaching its decisions,¹²⁹ although a November 2005 advocate general's opinion suggests that the retroactivity of decisions might be limited in exceptional cases if there is a "risk of serious economic repercussions" and "objective, significant uncertainty" about the EU law at issue.¹³⁰

Moreover, the ECJ has routinely rejected the defense that offending provisions are essential to the cohesion or coherence of member states' taxing statutes.¹³¹ To be sure, member states have sometimes responded with a tax-increasing measure to offset the potential effect of an ECJ decision on their national treasuries. This, for example, describes some member states' responses to the ECJ's decisions that would have required them to extend their corporate integration benefits both to residents of other member states and to investments in other member states by their own residents. Likewise,

128. The exceptions are cases eliminating incentives for domestic production, unless the country decides to extend the incentive to foreign production.

129. Case C-324/00, *Lankhorst-Hohorst GmbH v. Finanzamt Steinfurt*, 2002 E.C.R. I-11,779, ¶ 36 ("It is settled law that reduction in tax revenue does not constitute an overriding reason in the public interest which may justify a measure which is in principle contrary to a fundamental freedom."); see also *Joined Cases C-397 & C-410/98, Metallgesellschaft Ltd v. Comm'rs of Inland Revenue*, 2001 E.C.R. I-1727; Case C-307/97, *Compagnie de Saint-Gobain, Zweigniederlassung Deutschland v. Finanzamt Aachen-Innenstadt*, 1999 E.C.R. I-6161.

130. Press Release, Court of Justice of the Eur. Communities, Advocate General Tizzano Proposes that the German Tax Legislation Should Be Declared Incompatible with Community Law, but that the Effect of Such Incompatibility Should Be Limited in Time (Nov. 10, 2005), available at <http://curia.eu.int/en/actu/communiqués/cpos/aff/cpos0096en.pdf> (discussing Case C-292/04, *Meilicke v. Finanzamt Bonn-Innenstadt*, ¶ 34 (Nov. 10, 2005) (opinion of Advocate General Tizzano), <http://curia.eu.int/en/content/juris/index.htm> (search for "Case C-292/04")). Advocate General Tizzano suggested, for the first time, limiting the retroactivity of an ECJ decision. The case concerned dividends paid in 1995 through 1997 under the German imputation system, which favored dividends paid by domestic German companies over those paid to German individuals by companies resident elsewhere in the EU—a scheme held invalid by the ECJ in *Verkooyjen*. See *supra* Subsection II.A.1. The Advocate General denied relief in *Meilicke*, holding that Germany was responsible to issue refunds only for claims filed after the date of the *Verkooyjen* decision. It remains to be seen whether the ECJ will follow Advocate General Tizzano's opinion in this regard. See Alexander F. Peter, *ECJ Advocate General Breaks New Ground in German Tax Case*, *WORLDWIDE TAX DAILY*, Dec. 8, 2005, 2005 WTD 235-3 (LEXIS). See *supra* note 74 for additional discussion of revenue considerations.

131. See, e.g., Case C-319/02, *In re Manninen*, 2004 E.C.R. I-7477; Case C-9/02, *De Lasteyrie du Saillant v. Ministère de l'Économie, des Finances et de l'Industrie*, 2004 E.C.R. I-2409.

Germany's response to the ECJ's thin-capitalization decision,¹³² which struck down Germany's restrictions on the ability of companies to use interest deductions to strip taxable earnings out of Germany into lower-tax member states, was to extend these restrictions to domestic transactions. But specific responses such as these do not put the lie to the general proposition that ECJ decisions have tended to increase fiscal pressures on the member states.

ECJ decisions also are limiting the ability of member states to use tax policy to stimulate their own domestic economies. We now know that the member states' economies do not move in tandem; some enjoy boom times while others struggle economically.¹³³ But, as with revenue consequences, differences in economic circumstances are of no consequence under the ECJ's interpretations of the requirements of the treaties. One standard method for combating recessions, for example, is to increase depreciation allowances or to provide tax credits for new investments in plant and equipment. The United States often has used these techniques in efforts to stimulate its economy.¹³⁴ Economists frequently have argued that providing economic stimulus this way provides more bang for the buck than simply reducing corporate income tax rates, because benefits such as these apply only to new investments, while a corporate rate reduction reduces the tax burden on both old and new investments.¹³⁵ Nations typically make more rapid depreciation or investment tax credits available only to plant and equipment used domestically since the governments are attempting to stimulate their domestic economies. Similarly, it is common for nations—including the member states of the EU—to provide special tax breaks for research and development conducted domestically on the grounds that these expenditures provide special benefits to the domestic economy and that they stimulate the creation of high-paying jobs. Other tax benefits, such as for oil and gas exploration, also are sometimes limited to domestic business activities for national policy reasons.

132. *Lankhorst-Hohorst GmbH*, 2002 E.C.R. I-11,779.

133. See, e.g., Feldstein, *supra* note 6.

134. See GRAETZ & SCHENK, *supra* note 98, at 332-33, 338.

135. E.g., Lawrence H. Summers, *Taxation and Corporate Investment: A q-Theory Approach*, 1981 BROOKINGS PAPERS ON ECON. ACTIVITY 67, 118. Some economists go further to argue that the biggest bang for the buck is obtained with tax incentives for machinery and equipment. See, e.g., J. Bradford De Long & Lawrence H. Summers, *Equipment Investment and Economic Growth*, 106 Q.J. ECON. 445 (1991) (presenting empirical evidence that economic growth is greater in countries that invest more heavily in equipment). But see Alan J. Auerbach et al., *Reassessing the Social Returns to Equipment Investment*, 109 Q.J. ECON. 789 (1994) (arguing that, over the long run, capital intensity should not matter for economic growth).

But, as we have shown, the ECJ has held that the EC Treaty's promise of free movement of capital and free establishment—that is, of nondiscrimination against foreign production—may prohibit member states from taking any of these actions without extending equivalent benefits to foreign production within any other EU nation. This severely constricts the tax policy instruments available to member states. Extending tax breaks for investments or for research and development to such activities in other member states both increases the costs to a member state's treasury and simultaneously dilutes the economic stimulus of such measures to that member state. It is not surprising, therefore, that no nation has agreed to this expansive concept of nondiscrimination in any other tax or trade treaties.

The decisions of the ECJ, therefore, are putting significant fiscal pressure on the member states: They are limiting member states' ability to structure their own tax systems, including their ability to respond to their own domestic economic conditions by benefiting domestic savings or investment. ECJ decisions also are restricting member states' ability to prevent resident individuals or corporations from shifting assets or income to another member state with lower income tax rates.¹³⁶ This puts downward pressure on tax rates—especially for mobile capital—within the EU.

While the United Kingdom and Ireland seem to be the nations most vocal about the loss of control over their tax policy, this loss of fiscal flexibility should be of special concern for those member states that have adopted the Euro as their currency. These nations have explicitly ceded their control of monetary policy to the central European bank (which has made preventing inflation rather than stimulating economic growth its main concern). And they have pledged, through the Growth and Stability Pact, to control their deficits.¹³⁷ But now they find their ability to fashion their own fiscal policy, by controlling their own income taxes, to be substantially eroded by the decisions of the ECJ.

III. THE FORK IN THE ROAD

This state of affairs does not seem stable. Movement may occur in either of two directions: toward greater harmonization of income taxes within the EU or

136. See, e.g., Wolfgang Schön, *Tax Issues and Constraints on Reorganizations and Reincorporations in the European Union*, 34 TAX NOTES INT'L 197 (2004) (analyzing the legality of corporate exit taxes under the EC Treaty); see also *supra* text accompanying note 102.

137. The Growth and Stability Pact requires the budget deficits of member states to be below three percent of gross domestic product. *Qualified Majority Voting*, in ENCYCLOPEDIA OF THE EUROPEAN UNION 395 (Desmond Dinan ed., 2000).

toward a restructuring of the treaties and institutions of the EU to return greater fiscal autonomy to the member states. As Yogi Berra famously remarked, “When you get to a fork in the road, take it.” The ECJ has now brought Europe to that fork.

A. The Path of Greater Harmonization

In some sense, the widespread agreement that Europe now needs a constitution, rather than simply continuing to rely on existing treaties as its fundamental governing law, implies greater unification of the member states. But in the arena we are considering here—income taxation—the proposed constitution would not change the structure of governance within the EU. There have, however, long been forces pushing in the direction of greater harmonization of income taxes within Europe. The Commission, for example, has long maintained that harmonization of the corporate income taxes of the member states is essential to the full realization of the “common market” promised by the European treaties. As early as 1961, the Commission established working groups to study tax harmonization, and shortly thereafter it established a “Program for the Harmonization of Direct Taxes.”¹³⁸ The essential goal was to eliminate differences in taxation that affect the movement of capital and to coordinate the tax policies of member states as instruments of economic or social policies.¹³⁹ In the 1970s, the Commission pressed harmonization of member states’ income tax rates and tax bases even more vigorously, having identified a harmonized corporate income tax as a potential source of financing for European institutions.¹⁴⁰

To shorten a long story, the Commission’s goal of harmonization was thwarted by the Council.¹⁴¹ Some member states, notably France and Germany, have supported harmonization, and others, such as the Netherlands, have supported a minimum corporate income tax rate. Certain other members of the Council, however, have shown little interest in income tax harmonization measures other than those that limit opportunities for tax avoidance or

138. JIMÉNEZ, *supra* note 40, at 107, 109-11.

139. *Id.* at 110.

140. *Id.* at 115.

141. For the long story, see *id.* at 115-24.

evasion.¹⁴² Needless to say, the unanimity voting rule in the Council has inhibited the Commission's ability to do more.¹⁴³

The Commission seems to have accepted that there will be no harmonization of corporate tax rates among the member states—at least not in the foreseeable future—and has shifted its efforts to the goal of harmonizing the corporate tax base. The Commission now justifies this effort by emphasizing the simplification advantages of a uniform tax base to companies doing business in Europe, relying less on claims of potential benefits to the common market.

To some extent, this shift in argument became inevitable when the Commission abandoned its efforts to harmonize both the corporate income tax base and rates around a relatively narrow band of permissible variations. Corporate tax rates in the twenty-five EU countries currently extend over a considerable range. In 2005, Estonia had no income tax on undistributed corporate profits at all.¹⁴⁴ Cyprus and Ireland had relatively low rates (10% and 12.5% respectively), while Belgium, France, Germany, Italy, Luxembourg, and

142. *Id.*

143. For our purposes, it is not necessary to rehearse in great detail the Commission's ongoing efforts to harmonize member states' corporate income taxes. In 1990, the Commission issued a somewhat schizophrenic communication (1) urging harmonization on the ground that disparate member state tax systems inhibit the "development of the internal market" and, at the same time, (2) insisting that the member states should have the freedom to fashion their own tax systems except when this might cause "major distortions" in the operation of the internal market. *Commission Communication to Parliament and the Council, Guidelines on Company Taxation*, SEC (90) 601 final (Apr. 20, 1990); JIMÉNEZ, *supra* note 40, at 127. The Commission considered the 1992 Ruding Committee Report as generally supportive of its 1990 conclusions. JIMÉNEZ, *supra* note 40, at 131-35. The Council responded to both the Commission and the Ruding Report in November 1992, by emphasizing the centrality of taxation to member state sovereignty and by treating the principle of "subsidiarity"—minimum EU-level action—as a foregone conclusion. *Id.* at 136; *see also* ANTONIO ESTELLA, *THE EU PRINCIPLE OF SUBSIDIARITY AND ITS CRITIQUE* (2002). The European Parliament issued its views nearly two years later. It endorsed some of the Commission's conclusions, but it complicated the Commission's task by making clear its belief that any changes recommended by the Commission "should have regard to the general fiscal environment linked to" (1) "the establishment of the European Monetary Union," (2) member states' "budget constraints," (3) "implications for other forms of taxation of any changes in company tax bases or rates," and (4) the "wider role of company taxation as an instrument of economic policy." JIMÉNEZ, *supra* note 40, at 137 (quoting the Cox Report, which conveyed the European Parliament's response to the Commission).

144. EUROPEAN TAX HANDBOOK 2005, *supra* note 88, at 185.

Spain all had rates in excess of 30%.¹⁴⁵ This variation in rates creates substantial incentives for where to locate capital within the EU. With harmonization of rates now off the table, it is difficult for the Commission (or anyone else) to contend that harmonizing the tax base will produce neutrality in corporate decisionmaking within Europe. Both the history and current state of corporate tax harmonization efforts within Europe imply that competition for capital investments will remain an important feature of member states' tax policies for some time to come. No one versed in tax policy can comprehend the logic of allowing this to continue while banning all other forms of investment incentives, such as accelerated depreciation or tax credits. But this is precisely where Europe stands today.

One cannot help but ask whether the Commission's ongoing efforts to harmonize corporate tax bases is—despite its protestations—simply a stalking horse for a subsequent push to conform rates. The Commission's ongoing complaints about the unanimity requirement and its continuing calls for qualified majority voting on tax matters lend credence to this view.¹⁴⁶ But the United Kingdom, the Netherlands, and certain other member states show no sign of any willingness to cede their veto power over taxation measures. For now at least, harmonization of corporate tax rates throughout Europe seems to be at a dead end.

Putting aside the stalking horse view of the Commission's effort to harmonize member states' corporate tax bases but not their rates, let us examine what such a measure would accomplish. The Commission now justifies its harmonized base proposal as a method of simplifying EU corporate taxes and reducing the costs of tax compliance for EU companies,¹⁴⁷ and these two benefits should follow. In addition, harmonization of corporate tax bases in a manner approved by the Commission might reduce the number of cases likely to come before the ECJ. Presumably a Commission-led harmonization effort would attempt to purge from the member states' tax laws provisions that the Commission views as contravening the European treaties. As indicated

145. KPMG, CORPORATE TAX RATE SURVEY 2005, at 2-3, available at http://kpmg.com/om/PDF/212792%20Global%20Tax%20Rate_fin.pdf (including effects of subnational taxes on corporate income).

146. For a description of qualified majority voting, see *supra* note 15.

147. *Communication on Consolidated Corporate Tax Base*, *supra* note 126, at 5; *Communication on Tax Policy Priorities*, *supra* note 17, at 6; *Working Paper on Company Taxation*, *supra* note 80, at 384. The European Parliament recently endorsed the idea of a common company tax base. *European Parliament Adopts Report on Harmonized Tax Base*, *WORLDWIDE TAX DAILY*, Dec. 13, 2005, 2005 WTD 239-18 (LEXIS).

above, a PricewaterhouseCoopers study has concluded that the corporate tax laws of all twenty-five member states contain such provisions.¹⁴⁸

The Commission would couple the harmonization of the corporate base with apportionment of corporate tax revenues to the member states through a formula similar to that used within the United States. Such formulary apportionment should reduce (or perhaps even eliminate) the amount of residence-based taxation in Europe and thereby decrease the number of cases involving discrimination against foreign production coming before the ECJ. The Commission is urging that all members must use the same formula, a requirement that the U.S. experience shows to be wise. Historically, the U.S. states used an equally weighted three-factor formula that allocated a share of corporate income to each state based on the amounts of property, wages, and sales in the state. However, many U.S. states now weigh sales more heavily in their formula than property or wages. Some have even adopted sales-only formulas that encourage companies to locate property and jobs in-state while taxing income from in-state sales of goods produced out of state. Thus, if the EU were to mimic the United States by harmonizing its corporate tax base¹⁴⁹ and allocating the revenues to the member states by formulary apportionment, the U.S. experience suggests that, without a prohibition on extra weighting of sales, formulary apportionment would make it easy for member states to favor domestic investment, something the Commission has been litigating to prevent.¹⁵⁰

In the United States, Congress has the constitutional power to impose a uniform formula on the states by legislation, but it has never done so.¹⁵¹ In the EU, on the other hand, short of unanimous agreement on a single formula by

148. Press Release, PricewaterhouseCoopers, *supra* note 70.

149. In the United States, harmonization of the tax base has occurred because the states piggyback on the federal corporate tax and simply use that tax base as a starting point. In fact, there are some relatively minor variations among the states. See 1 JEROME R. HELLERSTEIN & WALTER HELLERSTEIN, *STATE TAXATION* ch. 7 (3d. ed. 1998 & Supp. 2005).

150. For further discussion of formulary apportionment, see *infra* text accompanying notes 200-207. The Commission seems to be recognizing some of these difficulties. For example, in a December 8, 2005 speech, László Kovács, the European Commissioner for Taxation and Customs, emphasized that even the harmonized tax base would be optional for member states. László Kovács, European Comm'r for Taxation and Customs, *The Future of EU Taxation Policy*, Speech to Tax Directors' Institute and Pricewaterhouse Coopers 5 (Dec. 8, 2005), available at http://europa.eu.int/comm/commission_barroso/kovacs/speeches/51201TDI.pdf.

151. See *Moorman Mfg. Co. v. Blair*, 437 U.S. 267, 280 (1978) ("It is clear that the legislative power granted to Congress by the Commerce Clause of the Constitution would amply justify the enactment of legislation requiring all states to adhere to uniform rules for the division of income.").

all of the member states, there is no legislative body with the power to compel a uniform formula. While it is certainly possible for the member states to agree unanimously to move not only to formulary apportionment, but also to a specific formula, this seems unlikely any time soon. Thus, even if the Commission succeeded in harmonizing the corporate tax base, it might fail to harmonize either tax rates or the formula for allocation of profits to the member states. If the member states then followed our states' example of fashioning formulas to provide themselves a competitive advantage, the Commission would likely return to the ECJ arguing that any formulas that favor domestic products, producers, or production violate the EC Treaty. Based on the ECJ decisions to date, we would expect the court to restrict member states' discretion over the formula, something that both our Supreme Court and our Congress have refused to do.

In sum, harmonization of member states' tax rates is not in the cards for the foreseeable future. And we fail to see how—without some relatively narrow band of permissible variation in rates—harmonization of the corporate tax base coupled with formulary apportionment will accomplish the mission of strengthening the internal market. Indeed, based on our nation's experience, it seems more likely that such a regime would simply be another way station along the current litigious road. Even if harmonization of tax rates could be achieved, it is not at all clear that the resulting uniformity would be desirable, given the differences in the member states' economies and in their preferences regarding the size of government and the use of tax incentives for economic or social programs.¹⁵²

Concerned that the obstacles to harmonization now seem too great to overcome, the Commission has also been pursuing what it calls “soft law” avenues to greater coordination among member states. The Commission, for example, has proposed “Codes of Conduct,” which are not legally binding on the member states, but allow them to pledge their cooperation.¹⁵³ And key Commission personnel have suggested that, if achieving unanimity is impossible, the search for “a negotiated solution adopted by consensus in a soft law format is the only available tool.”¹⁵⁴ Any such consensus may involve fewer than the full twenty-five EU member states and, if so, would apply only to

152. See George R. Zodrow, *Tax Competition and Tax Coordination in the European Union*, 10 INT'L TAX & PUB. FIN. 651 (2003).

153. See, e.g., Kovács, *supra* note 150, at 6; see also Chuck Gnaedinger, *EU Proposes Code of Conduct for Transfer Pricing Documentation*, 40 TAX NOTES INT'L 688 (2005).

154. Michel Aujean, Dir. of Analysis & Tax Policies, EU Comm'n, Conference Presentation: The Future of Nondiscrimination—Direct Taxation in Community Law (Oct. 21, 2005) (on file with authors).

those who agree.¹⁵⁵ In the meantime, the Commission fully intends to continue challenging member state income tax rules before the ECJ.¹⁵⁶

B. *The Path of Greater Autonomy*

The ECJ's tax decisions undoubtedly have produced headaches for the member states. As we have discussed, member states' claims that a provision is necessary to maintain the coherence of their income taxes have generally been rejected by the court. And the court has paid little heed to the negative impact of its decisions on the revenues of the member states. Over time, many member states have abandoned their shareholder-credit systems for integrating their corporate and individual income taxes. The ECJ has also curtailed member states' ability to provide tax incentives for domestic investment or for domestic research and development. ECJ decisions have also struck down (and threaten to strike down more) member state tax provisions designed to inhibit companies' ability to shift income to lower-tax member states. The court has, for example, invalidated member states' limitations on corporations' ability to strip earnings from higher- to lower-tax countries within the EU. And other member state limitations on domestic corporations' ability to locate income in lower-tax member states are in grave danger. ECJ precedents now threaten the extensive network of bilateral income tax treaties that has evolved since the 1920s, both within Europe and between EU member states and other nations. Indeed, the foreign tax credit mechanism for relieving double taxation—used for more than half a century in the United Kingdom and elsewhere—now seems vulnerable to an adverse ECJ judgment. Even the European Commissioner for Taxation has conceded that he is “not happy with the fact that EU tax policy is increasingly being made as a result of [ECJ] decisions,” admitting that “recent developments in this area could lead to a situation where it will become almost impossible for member states to protect their tax bases.”¹⁵⁷

The likelihood, however, that the ECJ's tax decisions, coupled with its other intrusions on member state sovereignty, will drive member states to

155. The EC Treaty provides for “enhanced cooperation” whenever at least eight member states agree. See EC Treaty art. 11; Otmar Thoemmes, *A Europe à Deux Vitesses for Enterprise Taxation?*, 32 *INTERTAX* 536 (2004).

156. Aujean, *supra* note 154; Kovács, *supra* note 150, at 12 (“One of the main tasks of the Commission under the EC Treaty is to ensure that member states respect their Treaty obligations, including, where necessary, by launching infringement proceedings against the Member States.”).

157. Kovács, *supra* note 150, at 13.

separate from the EU seems even more remote than the harmonization of member states' income tax rates. The European project has come too far and the economic and political transformation has been too great for anyone to predict that Europe is about to fall apart. Member states have many reasons to maintain their political and economic union even if many also wish to retain autonomy over their tax systems, especially over income taxation. Pulling Europe apart is one option, but not one that the member states or the people of Europe seem to desire.

On the other hand, the fiscal consequences of the ECJ's current path are becoming more and more difficult for the member states to swallow. They simply cannot afford to stand idly by and watch their corporate tax revenues shrink. Nor can they readily increase their own corporate tax rates. Competition for capital investments within Europe blocks this avenue as a practical matter. (In fact, corporate tax rates in Europe and the OECD have been declining in recent years.¹⁵⁸)

One potential response by the member states to the ECJ's erosion of their sovereign power to shape their own income taxes would be to restrict the authority of the ECJ over such matters.¹⁵⁹ A future revision of the treaties or a new constitution might limit the ability of the ECJ to strike down member states' income tax provisions. Such a limitation on the jurisdiction of the ECJ, however, would permit considerable mischief by the member states. As our review of the ECJ cases has shown, some member state tax provisions are potentially quite protectionist, and some have been adopted to serve precisely that purpose. The dilemma for the nations of Europe is to find a way to retain their autonomy over tax matters without undermining the internal market and, as a practical matter, severely restricting the four freedoms.

The basic difficulty is that while the nondiscrimination requirements of international income tax and trade treaties may be too narrow to accomplish European integration, the nondiscrimination requirement that has emerged through the decisions of the ECJ is too broad. It stifles the member states' essential ability to promote their own domestic economies. The ultimate question is whether there lies any viable middle ground between the limited nondiscrimination requirements of international tax and trade treaties and the unduly inhibiting version of nondiscrimination fashioned by the ECJ, which

158. CONG. BUDGET OFFICE, CORPORATE INCOME TAX RATES: INTERNATIONAL COMPARISONS 14-15 (2005); Chris Edwards, Dir. of Tax Policy, Cato Inst., *A Proposal for a Dual-Rate Income Tax*, Testimony to the President's Advisory Panel on Tax Reform (May 11, 2005) (accompanying presentation available at www.taxreformpanel.gov/meetings/docs/edwards_052005.ppt).

159. See, e.g., Timothy Lyons, *A Drive To Curb the Power of the ECJ*, 2005 B.T.R. 449.

does not allow for compromise among inconsistent principles. One alternative might be a slowing of ECJ intervention with more attention to the effect on the member states' fisc and a greater focus on protectionism as a potential middle ground. The court's inquiry might, for example, be redirected to whether the intent of the provision was protectionist.¹⁶⁰ The court also might move to mitigate the adverse impact of its decisions on member state revenues by limiting the retroactive effect of its decisions.¹⁶¹

In the absence of some pullback from the ECJ's current jurisprudence, we expect greater resistance by the member states. Already, several national courts within Europe have shown a reluctance to certify questions to the ECJ. They would rather interpret the requirements of European law themselves, even though certification is mandatory under the treaties if the governing European rule is unclear. The courts of Ireland, Italy, and Spain have never submitted a tax case to the ECJ for decision. If other member states were to follow this practice, they would restrict somewhat the ECJ's power, in effect diminishing its jurisdiction. In addition, member states have considerable power to discourage their domestic companies from challenging member state tax laws in the ECJ. More intensive and intrusive tax audits of litigants are one possibility—unseemly, to be sure, but nevertheless possible. Or member states might respond to ECJ decisions by extending restrictions to domestic companies rather than eliminating the offending provisions altogether. This was Germany's response after the ECJ struck down its limitations on interest deductions for payments to thinly capitalized foreign corporations.¹⁶² Member states could respond similarly to the *Marks & Spencer* decision by restricting the use of certain domestic losses. Indeed, extending restrictions to intrastate transactions is how U.S. states have sometimes responded to adverse U.S. Supreme Court decisions.¹⁶³

160. Cf. Donald H. Regan, *The Supreme Court and State Protectionism: Making Sense of the Dormant Commerce Clause*, 84 MICH. L. REV. 1091 (1986) (arguing that the U.S. Supreme Court should be concerned only with preventing purposeful protectionism in applying the dormant Commerce Clause).

161. A step in this direction has been suggested by the opinion of the Advocate General in *Meilicke*. Case C-292/04, *Meilicke v. Finanzamt Bonn-Innenstadt* (Nov. 10, 2005) (opinion of Advocate General Tizzano), <http://www.curia.eu.int/en/content/juris/index.htm> (search for "Case C-292/04"). The ECJ may also curb the revenue impact of its holdings by narrowing their scope. See Case C-446/03, *Marks & Spencer plc v. Halsey* (Dec. 13, 2005), <http://www.curia.eu.int/en/content/juris/index.htm> (search for "Case C-446/03"); see also *supra* notes 74, 130, 134 and accompanying text.

162. See *supra* notes 54-55, 132 and accompanying text.

163. Susannah Camic, *State Responses to Adverse Supreme Court Tax Decisions* (May 2004) (unpublished manuscript, on file with authors).

Alternatively, the Council and Parliament might limit the Commission's ability to bring cases either directly by reducing its mandate or indirectly by restricting its finances or increasing its workload (but not its personnel) in the tax arena. When the United Kingdom assumed the revolving presidency of the Council in 2005, the press indicated that curbs on the ECJ's tax jurisdiction would be on the agenda.¹⁶⁴

Another possibility would be greater restraint by the ECJ itself. The court might, for example, give greater weight to arguments based on the fiscal coherence of a member state's tax system.¹⁶⁵ There are signals that the court could be moving to a more cautious mode. One advocate general, for example, has suggested that revenue implications might be germane to the court when deciding whether to strike down tax legislation.¹⁶⁶ Another has suggested limiting the retroactive effect of court decisions.¹⁶⁷ And the court itself declined to hold that the benefits of an intra-European tax treaty must be extended to nationals of member states not a party to the treaty.¹⁶⁸ One knowledgeable European commentator has criticized this decision as a sign that the court may be softening its approach to European integration.¹⁶⁹ Alternatively, the court might fashion a less robust nondiscrimination requirement.¹⁷⁰

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164. Chris Giles, *UK Seeks To Curb European Tax Rules*, FIN. TIMES, June 20, 2005, at 1.
165. Compare Case C-204/90, *Bachmann v. Belgium*, 1992 E.C.R. I-249 (holding that the denial of a deduction to Belgian purchasers of foreign insurance was justified because proceeds would not be taxed in Belgium), with Case C-80/94, *Wielockx v. Inspecteur der Directe Belastingen*, 1995 E.C.R. I-2493 (holding that the denial of a deduction by the Netherlands for pension contributions by a nonresident was not justified even though receipts from the pension plan would not be taxable under the Netherlands-Belgium tax treaty). See generally *Marks & Spencer* (Dec. 13, 2005); MASON, *supra* note 5, at 94-101 (discussing the scope of fiscal cohesion).
166. Case C-475/03, *Banca Popolare di Cremona v. Agenzia Entrate Ufficio Cremona* (Mar. 17, 2005) (opinion of Advocate General Jacobs), <http://www.curia.eu.int/en/content/juris/index.htm> (search for "Case C-475/03").
167. Case C-292/04, *Meilicke v. Finanzamt Bonn-Innenstadt* (Nov. 10, 2005) (opinion of Advocate General Tizzano), <http://www.curia.eu.int/en/content/juris/index.htm> (search for "Case C-292/04"); see also Case C-374/04, *Test Claimants v. Comm'rs of Inland Revenue* (Feb. 23, 2006) (opinion of Advocate General Geelhoed), <http://www.curia.eu.int/en/content/juris/index.htm> (search for "Case C-374/04") (criticizing the court's decisions in *Bosal Holding* and *Marks & Spencer*).
168. Case C-376/03, *D. v. Inspecteur van de Belastingdienst*, 2005 ECJ CELEX LEXIS 349 (July 5, 2005).
169. Servaas van Thiel, *A Slip of the European Court in the D Case (C-376/03): Denial of the Most-Favoured-Nation Treatment Because of Absence of Similarity?*, 33 INTERTAX 454 (2005).
170. For two possibilities, see, for example, text accompanying notes 116-125.

Finally, the member states may simply divide, as they did with respect to monetary union, with some pursuing greater harmonization, while others insist on greater autonomy.¹⁷¹ These possible responses illustrate the potential for member states to maintain their separatism in the face of ECJ decisions without pulling the EU apart. Essentially, this is a form of “muddling through.”¹⁷²

IV. THE UNITED STATES: SIMILARITIES AND DIFFERENCES

A. Comparable Decisions of the U.S. Supreme Court

Europeans may be tempted to look to decisions of the U.S. Supreme Court in the hopes of finding a way through Europe’s conundrum. After all, the U.S. Supreme Court since the nineteenth century has decided many cases analogous to the ECJ cases we discuss here. The two U.S. constitutional provisions that explicitly address the taxing powers of the states—the Import-Export Clause¹⁷³ and the Duty of Tonnage provision¹⁷⁴—have not been important, but three other provisions have frequently been invoked: the Commerce Clause,¹⁷⁵ the Privileges and Immunities Clause,¹⁷⁶ and the Equal Protection Clause.¹⁷⁷ Most of the cases have been decided under the Commerce Clause, and the Supreme Court explicitly requires that a state taxing provision must not “discriminate against interstate commerce” in order to be upheld under that Clause.¹⁷⁸ It

171. Thoemmes, *supra* note 155, at 536 (observing that a “coalition of the willing” for greater harmonization could be formed under the “[e]nhanced [c]ooperation” provisions of the EC Treaty, which requires agreement of eight member states).

172. Charles E. Lindblom, *The Science of “Muddling Through,”* 19 PUB. ADMIN. REV. 79 (1959).

173. U.S. CONST. art. I, § 10, cl. 2 (“No State shall, without the Consent of the Congress, lay any Imposts or Duties on Imports or Exports . . .”).

174. *Id.* cl. 3 (“No State shall, without the Consent of Congress, lay any Duty of Tonnage . . .”).

175. *Id.* art. I, § 8, cl. 3 (“[Congress shall have power] [t]o regulate Commerce with foreign Nations, and among the several States, and with the Indian Tribes.”).

176. *Id.* art. IV, § 2, cl. 1 (“The Citizens of each State shall be entitled to all Privileges and Immunities of Citizens in the several States.”).

177. *Id.* amend. XIV, § 1 (“[N]or shall any State . . . deny to any person within its jurisdiction the equal protection of the laws.”). The Due Process Clause of the Fourteenth Amendment has also been important in state tax cases involving issues of jurisdiction to tax and extraterritorial taxation, but it is not germane to issues of nondiscrimination.

178. *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279 (1977). The other three requirements to satisfy the *Complete Auto* test are that (1) the activity taxed has a substantial nexus with the taxing state; (2) the tax is fairly apportioned to reflect the degree of activity

therefore seems worthwhile to inquire whether the ECJ might benefit from the U.S. jurisprudence. Implementing a coherent nondiscrimination requirement, however, has not proved to be any easier for the U.S. courts.

Walter Hellerstein, the leading legal analyst of the U.S. decisions, claims correctly that it is futile to attempt to reconcile the Supreme Court's "hundreds of decisions delineating the scope of state tax power over interstate business,"¹⁷⁹ and we shall certainly not undertake that task here. Professor Hellerstein describes the incoherence of these decisions:

[1] Two taxes that have a substantially similar impact on interstate commerce are accorded different constitutional treatment. [2] The Court, conceding that the "line is sometimes difficult to define with distinctness," nevertheless draws one that is discernable, if at all, only to itself. [3] The line drawn is then explained in terms that effectively assure the Court ample discretion to draw lines in the future as it deems appropriate, without providing any clear guidance whether a particular levy will fall on one side or the other.¹⁸⁰

It would be foolhardy, therefore, for Europeans to expect the U.S. Supreme Court to supply a way out of the mire, even if our political arrangements were similar, which they are not. Most importantly, the United States employs a federal corporate income tax that supplies both a uniform national corporate tax base and a minimum national tax rate.¹⁸¹ The United States also has relatively low state corporate tax rates,¹⁸² a more unified national economy than the EU, and a federal legislature that can both overturn Supreme Court judgments and enact legislation limiting the Court's power to nullify state

that occurs within the taxing state; and (3) the tax is fairly related to benefits provided by the state. *Id.*

179. Walter Hellerstein, *The U.S. Supreme Court's State Tax Jurisprudence: A Template For Comparison* 11 (Oct. 21, 2005) (unpublished manuscript, on file with authors) [hereinafter Hellerstein, *State Tax Jurisprudence*]; see also Walter Hellerstein, *Is "Internal Consistency" Foolish?: Reflections on an Emerging Commerce Clause Restraint on State Taxation*, 87 MICH. L. REV. 138 (1988) [hereinafter Hellerstein, *Internal Consistency*]; Walter Hellerstein & Dan T. Coenen, *Commerce Clause Restraints on State Business Development Incentives*, 81 CORNELL L. REV. 789 (1996).
180. Hellerstein, *State Tax Jurisprudence*, *supra* note 179, at 10 (quoting *In re State Tax on Ry. Gross Receipts*, 82 U.S. (15 Wall) 284, 296 (1872)).
181. See *supra* note 149.
182. Additionally, the fact that state corporate income taxes are deductible in determining federal taxable income typically reduces their financial impact by about one-third. See I.R.C. § 164 (West 2002 & Supp. 2005).

taxes.¹⁸³ Notwithstanding these critical differences, however, we shall look briefly at a handful of Supreme Court decisions, employing once again the analytical framework we used above for classifying the corporate tax decisions of the ECJ. As before, we begin with discrimination against out-of-state products (and services).

The Supreme Court has consistently struck down laws that discriminate against out-of-state products. According to the Court, the “paradigmatic example of a law discriminating against interstate commerce is the protective tariff or customs duty, which taxes goods imported from other States, but does not tax similar products produced in State.”¹⁸⁴ Because the Court has frequently taken such a firm position against these taxes, states have adopted them with decreasing frequency, so the Court, at least in recent years, has rarely found itself in a position to invalidate them. One such decision struck down state sales tax exemptions in Hawaii for two kinds of locally produced liquors, where these exemptions were intended to encourage the growth of the infant industries that produced the liquors.¹⁸⁵ Similarly, the Court found an Ohio tax credit against the state’s motor vehicle fuel sales tax to be discriminatory.¹⁸⁶ Under that provision, taxpayers could receive a credit for ethanol sold (as a component of gasohol) by fuel dealers, but only if the ethanol was produced either in Ohio or in a state that granted tax advantages similar to those granted to ethanol produced in Ohio.¹⁸⁷

The Court has also invalidated as discriminatory tax provisions that favor in-state provision of services—a type of tax that states seem to enact with increasing frequency. For example, the Court rejected a New York law that

183. For elaboration of these distinctions, see, for example, Walter Hellerstein & Charles E. McLure, Jr., *Lost in Translation: Contextual Considerations in Evaluating the Relevance of US Experience for the European Commission’s Company Taxation Proposals*, 58 BULL. INT’L FISCAL DOCUMENTATION 86 (2004).

184. *West Lynn Creamery, Inc. v. Healy*, 512 U.S. 186, 193 (1994).

185. *Bacchus Imports, Ltd. v. Dias*, 468 U.S. 263 (1984). As discussed earlier, the categories of foreign products, producers, and production can overlap. Although some commentators, including Hellerstein, have classified this case as a tax incentive for in-state production, Hellerstein, *State Tax Jurisprudence*, *supra* note 179, at 22, 29, we believe it is better analyzed as a barrier to out-of-state products, because the provision seems primarily aimed against importation of non-Hawaii products, rather than against non-Hawaii production by Hawaiian taxpayers.

186. *New Energy Co. of Ind. v. Limbach*, 486 U.S. 269 (1988).

187. The Court itself viewed the Ohio regime as erecting “an economic barrier against competition” that was “equivalent to a rampart of customs duties.” *Limbach*, 486 U.S. at 275 (quoting *Baldwin v. G.A.F. Seelig, Inc.*, 294 U.S. 511, 527 (1935)). The taxes at issue in these cases were taxes on consumption, not income, but it is unclear whether or how that would affect the Court’s analysis.

attempted to encourage stock trading in New York by offering a fifty percent reduction on the stock transfer tax levied on in-state stock transactions by non-New York residents.¹⁸⁸ The statute also limited the total liability of any taxpayer to \$350 for a single transaction involving a New York sale. The Court struck this statute down on the ground that it offered unconstitutionally preferential treatment to stock trading services provided in New York.

With respect to producers, the Court has made clear that the Commerce Clause prevents state tax laws from discriminating against those from out of state. In several of these cases, states have offered exemptions from state taxes to in-state producers, thereby discriminating against their out-of-state competitors. For example, West Virginia imposed a gross receipts tax on manufacturing corporations engaged in the business of selling tangible property in the state and allowed only local manufacturers exemptions from the tax.¹⁸⁹ Similarly, Washington imposed a "business and occupation" tax on companies for the privilege of engaging in economic activities in the state, including both manufacturing and wholesale sales.¹⁹⁰ The tax included a "multiple activities exemption" under which local businesses involved in both selling and manufacturing could exempt from the manufacturing tax the portion of their output subject to the wholesale tax.¹⁹¹ The Court struck down this arrangement on the ground that both taxes "facially discriminated" against out-of-state companies attempting to do business in Washington.¹⁹² A third example of a case invalidating discrimination against out-of-state producers involved a Massachusetts tax and subsidy program under which every milk producer doing business within the state had to make monthly "premium payments" of an amount pegged to fluctuations in the national price of milk.¹⁹³ The state then distributed the monthly collections to in-state dairy farmers, who received shares in direct proportion to their contribution to the state's total production of raw milk. While both in-state and out-of-state producers made payments under this program, only in-state producers received compensatory benefits from the fund, a net result the Court found discriminatory.

188. *Boston Stock Exch. v. State Tax Comm'n*, 429 U.S. 318 (1977).

189. *ARMCO v. Hardesty*, 467 U.S. 638 (1984).

190. *Tyler Pipe Indus., Inc. v. Wash. State Dep't of Revenue*, 483 U.S. 232, 232 (1987).

191. *Id.*

192. *Id.* at 244, 248; see also Hellerstein, *Internal Consistency*, *supra* note 179, at 144 (noting that, if one assumes that every state adopts this kind of arrangement, cross-border activity gets taxed twice, while the taxpayer who confines its activity to a single state is taxed only once).

193. *West Lynn Creamery, Inc. v. Healy*, 512 U.S. 186 (1994).

The U.S. Supreme Court also has struck down state taxes that discriminate against out-of-state production, but this type of case does not occur frequently.¹⁹⁴ One such example concerned a New York statute that required parent companies owning domestic international sales corporations (DISCs) to consolidate the assets and liabilities of the DISC with those of the parent company.¹⁹⁵ The state provided the parent companies with a credit that lowered the effective tax rate on DISC income to thirty percent of the otherwise applicable rate. This credit applied only to gross receipts from export products shipped from inside New York, and, crucially, the magnitude of the credit depended on the percentage of business the DISC carried out in New York. The Court found that this law discriminated against companies producing outside of New York because an increase in out-of-state DISC-related production reduced the in-state tax benefit. Another decision along somewhat similar lines struck down a tax on the “first use” within the state of any natural gas, but allowed a variety of exclusions and credits against the tax for companies that had already paid a “severance” tax on the extraction of oil and gas within Louisiana.¹⁹⁶ According to the Court, this tax arrangement discriminated against interstate commerce by encouraging companies “to invest in mineral exploration and development within Louisiana rather than . . . in other States.”¹⁹⁷ On another occasion, the Court invalidated a North Carolina “intangible property tax” on the fair market value either of stock owned by state residents, or of stock “having a business, commercial or taxable situs in the State.”¹⁹⁸ The state imposed the tax at a rate of 0.25%, but residents could calculate their tax liability by taking a taxable percentage deduction equal

194. This is generally due to the U.S. states’ use of formulary apportionment for allocating corporate taxes among the states, which reduces the role of residence taxation because the allocation factors generally relate to source or consumption. See *infra* text accompanying notes 200-207. There are more state cases involving this type of discrimination. *E.g.*, *R.J. Reynolds Tobacco Co. v. City of New York Dep’t of Finance*, 667 N.Y.S.2d 4 (App. Div. 1997) (holding that an accelerated depreciation limited to in-state property discriminates against interstate commerce). See generally Hellerstein, *State Tax Jurisprudence*, *supra* note 179, at 24-28 (discussing state court precedents). Discrimination against non-U.S. source income under a state income tax would violate the Foreign Commerce Clause. See, *e.g.*, *Kraft Gen. Foods, Inc. v. Iowa Dep’t of Revenue & Fin.*, 505 U.S. 71, 79 (1992) (invalidating a dividends-received deduction for income from domestic but not foreign corporations and asserting that “a state’s preference for domestic commerce over foreign commerce is inconsistent with the Commerce Clause”).

195. *Westinghouse Elec. Corp. v. Tully*, 466 U.S. 388 (1984).

196. *Maryland v. Louisiana*, 451 U.S. 725, 731 (1981).

197. *Id.* at 757.

198. *Fulton Corp. v. Faulkner*, 516 U.S. 325, 327 (1996) (internal quotation marks omitted).

to the fraction of the issuing corporation's sales, payroll, and property located in North Carolina—the factors that determined the amount of corporate tax paid to the state. The Court found that this calculation discriminated against companies that located their production outside of the state.

To recapitulate, the Supreme Court has invalidated state tax laws favoring in-state products, producers, and production. On the other hand, its jurisprudence has not yet had the same reach as the decisions of the ECJ, particularly with respect to the third category.¹⁹⁹ The primary reason for this, we think, is not found in the differences between the two courts' approaches to nondiscrimination, but rather in the fact that state taxation of corporate "business income"²⁰⁰ typically occurs through formulary apportionment. Under this system, the states determine their corporate tax revenues by allocating shares of the total corporate tax base to each state depending on that state's share of wages, property, and sales. Wages and property are factors of production, while sales relate to consumption. Three-factor formulary apportionment divides the state income tax base among source and consumption states, largely without regard to a company's residence. Residence-based taxation of corporate income is thus much less important to the U.S. states than it is to the EU member states. It is therefore not surprising that the U.S. Supreme Court has been less concerned than the ECJ with discrimination by states against out-of-state production by their residents.²⁰¹

The great advantage of formulary apportionment is that it avoids the thorny problem (which haunts tax administrations throughout the world) of having to determine related-company transfer prices to measure each state's income. But there is a rub. Economists regard formulary allocation of income

199. See, e.g., Charles E. McLure, Jr., *The Long Shadow of History: Sovereignty, Tax Assignment and Judicial Decisions on Corporate Income Taxes in the US and the EU* 10 (unpublished manuscript, on file with authors) ("[T]he conflict between state tax sovereignty and the dormant Commerce Clause has been nowhere near as great as the analogous conflict in the EU.").

200. Most states define business income under the Uniform Division of Income for Tax Purposes Act or a substantially similar statute as "income arising from transactions and activity in the regular course of the taxpayer's trade or business." UNIF. DIV. INCOME TAX PURPOSES § 1(a), 7A U.L.A. 147 (2002). "Nonbusiness income" is typically allocated to a particular state or states based either on the situs of the property giving rise to the income (e.g., rents from real property) or on the taxpayer's commercial domicile (e.g., interest and dividends not related to the taxpayer's trade or business).

201. The ECJ also has more difficulty limiting its decisions in this manner because of the Treaty's prohibition against state aid. See *supra* text accompanying notes 96-99. It is worth recalling that the Supreme Court, unlike the ECJ, has considerable discretion regarding which cases it will hear.

taxes as essentially imposing burdens on the elements of the formula.²⁰² The U.S. states have found that the wage element of the formula increases the tax burden on locating jobs within the state and that the property element burdens the location of capital within the state. Consequently, over time states have moved toward weighing most heavily the sales element of the formula.²⁰³ Iowa was the first state to eliminate completely the property and wage aspects of the formula and to use only sales in its formula.²⁰⁴ In *Moorman Manufacturing Co. v. Bair*,²⁰⁵ the U.S. Supreme Court upheld the constitutional validity of Iowa's sales-only formula for allocating corporate profits. For many years, Iowa had been the only state to use a sales-only formula for apportioning corporate income, but five additional states have now moved to a sales-only formula, and more than half of the states weigh sales more heavily than the property or wage factors.²⁰⁶ Under the U.S. Constitution, Congress has the power to require the states to adopt uniform formulas, but, so far at least, it has declined to act.

Dissenting in *Moorman*, Justice Powell described his view of what was at stake: "Iowa's use of a single-factor sales-apportionment formula—though facially neutral—operates as a tariff on goods manufactured in other States and as a subsidy to Iowa manufacturers selling their goods outside of Iowa."²⁰⁷ However, a majority of the Court upheld Iowa's sales-only formula by refusing to accept the three-part formula as the appropriate baseline for assessing nondiscrimination. In other words, a sales-only formula does not favor in-state

202. E.g., Austan Goolsbee & Edward L. Maydew, *Coveting Thy Neighbor's Manufacturing: The Dilemma of State Income Apportionment*, 75 J. PUB. ECON. 125 (2000); Charles E. McLure, Jr., *The State Corporate Income Tax: Lambs in Wolves' Clothing*, in *THE ECONOMICS OF TAXATION* 327 (Henry J. Aaron & Michael J. Boskin eds., 1980).

203. Kirk J. Stark, *The Quiet Revolution in U.S. Subnational Corporate Income Taxation*, 23 ST. TAX NOTES 775, 780-82 (2002).

204. *Id.* at 780.

205. 437 U.S. 267 (1978).

206. Georgia, Illinois, Massachusetts, Nebraska, and Oregon have adopted single-factor sales formulas, and about half the states have formulas that double-weight sales in their apportionment formulas. JEROME R. HELLERSTEIN & WALTER HELLERSTEIN, *STATE AND LOCAL TAXATION: CASES AND MATERIALS* 610-11 (8th ed. 2005); see also Stark, *supra* note 203, at 780-82.

207. *Moorman*, 437 U.S. at 283-84 (Powell, J., dissenting). We do not question Justice Powell's characterization of Iowa's sales-only formula as a subsidy to exports (when compared to the three-part formula), but since sales of both Iowa and out-of-state products enter equally into Iowa's tax calculation, we do not agree that its formula necessarily operates as a tariff. See also Charles E. McLure, Jr. & Walter Hellerstein, *Does Sales-Only Apportionment of Corporate Income Violate International Trade Rules?*, 25 ST. TAX NOTES 779 (2002) (arguing that a single sales factor formula may be an illegal export subsidy under the international trade treaties).

production if one ignores other states' three-part formulas or if one assumes that all states have moved to a sales-only formula. This result provides American states a means of favoring in-state production that does not exist in the EU.

An important case currently before the Supreme Court may provide some insight into whether its approach to discrimination will move closer to that of the ECJ regarding outgoing investments. In *Cuno v. DaimlerChrysler, Inc.*,²⁰⁸ the Sixth Circuit Court of Appeals allowed an abatement from local property taxes but invalidated an Ohio investment tax credit for new investments in Ohio. Both benefits were intended to encourage a company to locate a manufacturing facility in Ohio. The appellate court struck down the investment tax credit on the ground that this incentive favored in-state over out-of-state investment.²⁰⁹ Even though nearly all of the fifty states provide incentives for local investments, relatively few of these have been challenged, and the Supreme Court has not yet squarely confronted the question of their validity.²¹⁰ If affirmed by the Supreme Court, the *Cuno* decision would invalidate a wide variety of tax incentives enacted to favor in-state investments and would move the United States further down the path taken by the ECJ with respect to this type of discrimination—and further into the labyrinth of impossibility we have described.²¹¹

208. 386 F.3d 738 (6th Cir. 2004), cert. granted sub nom. DaimlerChrysler Corp. v. Cuno, 126 S. Ct. 36 (2005) (No. 04-1704).

209. The court stated:

[A]s between two businesses, otherwise similarly situated and each subject to Ohio taxation, the business that chooses to expand its local presence will enjoy a reduced tax burden, based directly on its new in-state investment, while a competitor that invests out-of-state will face a comparatively higher tax burden because it will be ineligible for any credit against its Ohio tax.

Cuno, 386 F.3d at 743.

210. One analyst claims that forty-six states offer more than 330 statutory income or franchise tax credits. Timothy H. Gillis, *Sixth Circuit Bans Ohio Tax Credit Under the Commerce Clause, Casting a Pall on Incentives*, 101 J. TAX'N 359, 360 (2004). Another survey of forty-eight states found that only Wyoming had not enacted at least one location incentive between 1991 and 1993. Peter D. Enrich, *Saving the States from Themselves: Commerce Clause Constraints on State Tax Incentives for Business*, 110 HARV. L. REV. 377, 383-84 (1996); see also Chris Micheli, *A 50-State Comparison of Tax Incentives for Manufacturing Equipment Purchases*, 12 ST. TAX NOTES 1739 (1997) (explaining that nearly all states provide tax and other economic incentives for local economic activity).

211. The Supreme Court may refuse to reach the merits in this case on the ground that *Cuno* and the other plaintiffs lack standing. See *DaimlerChrysler Corp. v. Cuno*, 126 S. Ct. 36, 36 (2005) (granting certiorari and directing the parties to brief the question of “[w]hether respondents have standing to challenge Ohio’s investment tax credit”).

While some, including Professor Hellerstein,²¹² have argued that *Cuno* can readily be distinguished from *Moorman*, we disagree. The Ohio investment credit is simply a less expensive method of favoring in-state over out-of-state investments.²¹³ Rather than using a sales-only formula to avoid taxing any property located in the state, the credit is directed only at new investments. While it is not our main subject here, we think the U.S. Supreme Court should uphold Ohio's investment credit incentive and avoid stepping further into the conundrum that exists under the ECJ's decisions.²¹⁴ In taking this position, however, we should make clear that we need not endorse local tax incentives to do so. The Commerce Clause gives Congress the power to determine the extent to which such incentives should be allowed. Legislation has been introduced in Congress that would permit investment tax credits of the sort struck down by the Sixth Circuit in *Cuno* and would generally authorize states to provide tax incentives that otherwise might be held to be unconstitutionally discriminatory.²¹⁵ These bills also attempt not to overturn the remainder of the Supreme Court's Commerce Clause jurisprudence—admittedly a difficult task.²¹⁶ But Congress, not the Court, is the most appropriate body to decide whether to permit states to provide incentives for local investments, and if Congress speaks, it will almost certainly respond affirmatively.

B. Implications of the ECJ Decisions for the United States

We began our discussion of the Supreme Court decisions in the previous Section by asking if they could help resolve the conundrum created by the ECJ. Let us now turn the question around and ask what, if anything, the

212. Hellerstein, *State Tax Jurisprudence*, *supra* note 179, at 29-34.

213. Another example would be states' piggybacking on the domestic manufacturing provision of § 199 of the Internal Revenue Code. I.R.C. § 199 (West Supp. 2005).

214. A further reason to avoid striking down Ohio's investment tax credit is the fact that direct subsidies to encourage in-state production have been permitted by the Supreme Court's interpretations of the U.S. Constitution. See Edward A. Zelinsky, *Cuno v. DaimlerChrysler: A Critique*, 34 ST. TAX NOTES 37 (2004); Edward A. Zelinsky, *Restoring Politics to the Commerce Clause: The Case for Abandoning the Dormant Commerce Clause Prohibition on Discriminatory Taxation*, 29 OHIO N.U. L. REV. 29 (2002). Europe does not have the same discontinuity between tax incentives and direct expenditures because of the Treaty's prohibitions against state aid. See *supra* text accompanying notes 96-99.

215. H.R. 2471, 109th Cong. (2005); S. 1066, 109th Cong. (2005). These bills are identical.

216. See Walter Hellerstein, *Cuno and Congress: An Analysis of Proposed Federal Legislation Authorizing State Economic Development Incentives 3* (2005) (unpublished manuscript, on file with authors) ("Congress must act with surgical precision if it is to perform the operation without killing the patient.").

jurisprudence of the ECJ implies for the United States. We will examine implications for U.S. judicial decisions, tax treaty provisions, WTO constraints on taxation, European bilateral tax treaties, and the level of corporate taxation in the EU.

The first issue is whether the ECJ's view of the European requirements of nondiscrimination might find its way into the jurisprudence of U.S. courts. There are two contexts in which this might occur: first, in the Supreme Court's interpretations of the nondiscrimination requirements of the Commerce Clause of the U.S. Constitution in cases concerning state taxation of interstate commerce; and second, in judicial interpretations of the nondiscrimination requirements of U.S. bilateral income tax treaties.

Commentators have frequently remarked – sometimes unfavorably – that in recent years the Supreme Court of the United States has paid attention to practices and judicial opinions from abroad in interpreting the U.S. Constitution.²¹⁷ It would therefore be no surprise for the ECJ's nondiscrimination jurisprudence, over time, to influence the Supreme Court's decisions involving the constitutionality of U.S. state tax provisions. While, as we have made clear, these cases arise in an institutional and political context quite different from Europe's, they often involve similar issues: the legality of measures by state governments that may discriminate against the free interstate movement of goods, services, labor, or capital.

Our discussion of both the legal and fiscal policy implications of the ECJ's corporate tax decisions and of the U.S. Supreme Court's struggle with similar issues makes clear that we would not regard importation of ECJ jurisprudence by the U.S. Supreme Court as a positive development. We have emphasized the differences between the European and U.S. political structures and contexts, including the existence of a U.S. federal income tax.²¹⁸ Most importantly, Europe has no legislative body with authority comparable to our Congress's to act concerning these issues. Moreover, the ECJ's nondiscrimination jurisprudence is, in our view, a quest for an unattainable goal in the absence of harmonized income taxes – the simultaneous achievement of neutrality based on both origin and destination. For that reason, among others, it is inherently unstable. Despite the serious shortcomings of U.S. Supreme Court decisions in this context, looking to the ECJ for help does not seem wise.

²¹⁷. See, e.g., Vicki C. Jackson, *Constitutional Comparisons: Convergence, Resistance, Engagement*, 119 HARV. L. REV. 109 (2005); Jeremy Waldron, *Foreign Law and the Modern Ius Gentium*, 119 HARV. L. REV. 129 (2005); Ernest A. Young, *Foreign Law and the Denominator Problem*, 119 HARV. L. REV. 148 (2005).

²¹⁸. See *supra* text accompanying note 183.

In the quite different context of federal courts interpreting the nondiscrimination clauses of bilateral U.S. income tax treaties, we think it is unlikely that the ECJ's cases will have any noticeable impact on the decisions of U.S. courts.²¹⁹ Recall that U.S. obligations under the tax treaties' nondiscrimination clauses extend only to inbound investments—in this case, investments in the United States—by individuals or companies who are neither citizens nor residents of the United States. Both the U.S. Department of the Treasury and U.S. courts have taken a more limited view of the scope of this obligation than is implied by the ECJ's view of the nondiscrimination requirements of the EC Treaty. The United States, for example, has long insisted that its thin-capitalization rules,²²⁰ which were intended principally to limit the ability of U.S. subsidiaries of foreign parents to strip earnings out of the United States, are not discriminatory on the ground that they affect all entities exempt from U.S. taxation, not just foreigners.²²¹ The ECJ, in contrast, struck down similar German restrictions on interest deductions.²²² Additional examples exist. The ECJ, for example, has invalidated "exit taxes" that apply to taxpayers leaving one member state for another, while the United States allows such taxes.²²³ It seems unlikely that the ECJ decisions concerning discrimination against inbound investors will, without more, affect U.S. courts' determinations of what constitutes discrimination under U.S. bilateral income tax treaties.

A more likely course is that the ECJ cases finding discrimination against inbound investments will affect interpretations by the OECD of the nondiscrimination clause of its model treaties.²²⁴ Both ECJ interpretations of EC Treaty requirements and U.S. and OECD interpretations of the nondiscrimination requirements of income tax treaties require that the source country not treat a branch or subsidiary of a foreign company doing business

219. See also Bennett, *supra* note 30 (manuscript at 2-3, 31-32).

220. I.R.C. § 163(j) (West 2002 & Supp. 2005).

221. See Bennett, *supra* note 30 (manuscript at 19).

222. Case C-324/00, Lankhorst-Hohorst GmbH v. Finanzamt Steinfurt, 2002 E.C.R. I-11,779.

223. See Case C-9/02, De Lasteyrie du Saillant v. Ministère de l'Économie, des Finances et de l'Industrie, 2004 E.C.R. I-2409 (striking down a French tax for transfer of stock abroad). The United States, in contrast, believes that it is consistent with its treaty obligations to apply a toll charge under I.R.C. § 367(e)(2) (2000) when appreciated assets are transferred to foreign parents. I.R.S. Notice 87-66, 1987-2 C.B. 376 (rendered obsolete, but not repealed by, Rev. Rul. 2003-99, 2003-2 C.B. 388). Bennett, *supra* note 30 (manuscript at 42-43), concludes that a member state provision such as § 367(e)(2) would be struck down by the ECJ.

224. See OECD MODEL CONVENTION, *supra* note 30, art. 24; Bennett, *supra* note 30 (manuscript at 54-55).

in the source country (a “permanent establishment” in the language of the treaties) less favorably than it treats a domestic branch or subsidiary doing business in that country. The main distinction is that the ECJ’s nondiscrimination requirements also apply to foreign portfolio investors, while the income tax treaty rules do not. The ECJ’s cases finding discrimination in cases involving services supplied by a foreigner also go beyond the income tax treaties’ nondiscrimination requirements. Over time, the OECD model income tax treaty (and the OECD’s interpretations thereof) could move closer to the ECJ’s case law when inbound investments are at issue. Although the United States has always published its own model income tax treaty, which differs in some respects from the OECD model, the United States has also always been heavily influenced by the OECD model and its interpretations. We would not be surprised, therefore, if the U.S. model treaty also moved toward a more comprehensive view of discrimination regarding inbound investments.²²⁵

Neither the OECD’s model income tax treaty nor any U.S. bilateral income tax treaty limits the taxation rights of the home country regarding outbound investments, other than those articles requiring that double taxation be addressed either through a credit for foreign taxes or an exemption for foreign income.²²⁶ Although the OECD has announced that it is reexamining the scope of nondiscrimination in the tax treaties,²²⁷ which conceivably could lead to a rule that applied to outgoing investment, we find it inconceivable that the United States would agree to expand its income tax treaties to mimic the ECJ’s jurisprudence in this context. The United States is simply not going to negotiate away its ability to provide incentives for domestic investments or other activities, such as research and development or domestic exploration for energy resources.

A third forum in which the ECJ’s nondiscrimination jurisprudence might affect U.S. tax policy is the WTO. GATT (and its successors), which the WTO is charged with enforcing, prohibits subsidies for exports. As we have indicated, this has led the WTO (and its predecessors) to strike down certain U.S. income tax provisions on the ground that they provided benefits to domestic exporters not available to foreign producers. In 2004, Congress responded by substituting a special deduction available only to domestic manufacturing activities.²²⁸ Under WTO rules, as currently interpreted, this kind of subsidy is valid because it is available for the domestic manufacture of

225. See Bennett, *supra* note 30 (manuscript at 53-55).

226. See *supra* text accompanying note 32.

227. See Bennett, *supra* note 30 (manuscript at 3 n.4).

228. I.R.C. § 199 (West Supp. 2005).

goods, whether exported or not. The ECJ, on the other hand, would likely strike down such a provision as discrimination against foreign production—a violation of the free movement of capital or the free establishment guarantee of the EC Treaty. It is conceivable—but unlikely—that the WTO might also someday extend its reasoning regarding export subsidies to this type of subsidy on the ground that it inhibits the free movement of goods and services. This would be a major expansion of constraints on national legislation by the WTO, which, for both the legal and fiscal policy reasons we have discussed here, would be greatly resisted by many WTO members, including the United States. We do not expect the WTO to go this far in the absence of explicit authorization in a new treaty—authorization that surely will not be forthcoming.

With regard to the extensive network of bilateral income tax treaties now in force throughout the world, the ECJ jurisprudence poses another fundamental question: Can the bilateral nature of these treaties be sustained when an EU member state is one of the parties?²²⁹ In a number of tax cases, the ECJ has made clear that, along with their other taxing powers, member states must exercise their rights to enter into tax treaties in a manner that is consistent with EU law.²³⁰ When the ECJ has found that a bilateral treaty violates one of the four freedoms, it has typically required the member state at fault to extend treaty benefits unilaterally to residents of other member states.²³¹ Whether member states will be able to maintain treaties on a bilateral basis at all, however, has been called into question by the ECJ's decision in the so-called *Open-Skies* cases.²³² In those cases, the ECJ held that clauses in bilateral air transport agreements between the United States and various member states, which limited benefits to nationals of the contracting member state, violated the freedom of establishment requirement of the EC Treaty. This created a

229. See, e.g., Ruth Mason, U.S. Tax Treaty Policy and the European Court of Justice (Oct. 21, 2005) (unpublished manuscript, on file with authors) (arguing for a multilateral tax treaty between the United States and the EU member states).

230. See, e.g., Case C-307/97, *Compagnie de Saint-Gobain, Zweigniederlassung Deutschland v. Finanzamt Aachen-Innenstadt*, 1999 E.C.R. I-6161; Case C-336/96, *Gilly v. Directeur des services fiscaux du Bas-Rhin*, 1998 E.C.R. I-2793.

231. E.g., *Saint-Gobain*, 1999 E.C.R. I-6161.

232. Case C-475/98, *Comm'n v. Austria*, 2002 E.C.R. I-9797; Case C-471/98, *Comm'n v. Belgium*, 2002 E.C.R. I-9681; Case C-467/98, *Comm'n v. Denmark*, 2002 E.C.R. I-9519; Case C-476/98, *Comm'n v. Germany*, 2002 E.C.R. I-9855; Case C-472/98, *Comm'n v. Luxembourg*, 2002 E.C.R. I-9741; Case C-468/98, *Comm'n v. Sweden*, 2002 E.C.R. I-9575; Case C-466/98, *Comm'n v. United Kingdom*, 2002 E.C.R. I-9427; see also Georg W. Kofler, *European Taxation Under an 'Open Sky': LoB Clauses in Tax Treaties Between the U.S. and EU Member States*, 35 TAX NOTES INT'L 45 (2004).

dilemma since it is not possible for a European member state to extend the treaty benefits granted to it by the United States unilaterally to nationals of other member states. Nor could any member state force the United States to allow all EU nationals to enjoy the treaty benefits. Ultimately, the bilateral air transport treaties were saved when the United States agreed to new language allowing ownership and control by EU nationals of other member states. As a result, British nationals, for example, may now own and control a French airline and take advantage of the French-U.S. treaty.²³³

Bilateral income tax treaties between EU member states and the United States now routinely contain "limitations on benefits" clauses, which are intended to limit the treaties' benefits to tax residents of the contracting state.²³⁴ The treaty between the United States and the Netherlands, for example, allows its reduced withholding tax rates on dividends, interest, and royalties to companies only if "more than 30 percent of the aggregate vote and value . . . is owned, directly or indirectly, by qualified persons resident in the Netherlands."²³⁵ While their purposes are generally the same, the details of these limitations clauses vary, depending on when the treaty was negotiated and sometimes on specific bilateral considerations.²³⁶ The ECJ's *Open-Skies* decisions suggest that these clauses may have to be renegotiated to permit benefits to nationals of other member states.

The *Open-Skies* cases, along with certain tax cases,²³⁷ raise the more fundamental question of whether any EU country will be able to enter into a treaty with a non-EU country that treats its own nationals more favorably than nationals of any other EU member state. The crucial issue for the United States would then be whether the ECJ has imposed a type of most-favored-nation rule that, in essence, overrides the bilateral nature of the tax treaty. An opinion by the Advocate General in a recent ECJ case involving claims by a German resident for a wealth tax exemption the same as that granted by the Netherlands in a bilateral treaty to residents of Belgium suggested that—at

233. No intra-European bilateral transport agreements have, however, been entered into since the *Open-Skies* decisions.

234. See, e.g., U.S. Model Income and Capital Tax Convention Treaty art. 22 (1996) (U.S. Dep't of the Treasury).

235. Tax Convention, U.S.-Neth., art. 26, ¶ 4, Dec. 18, 1992, S. TREATY DOC. NO. 103-6 (1993).

236. Compare Tax Convention, U.S.-F.R.G., art. 28, Aug. 29, 1989, S. TREATY DOC. NO. 101-10 (1990) (establishing limitations on benefits), with Tax Convention, *supra* note 235, art. 26, ¶ 4.

237. Case C-307/97, *Compagnie de Saint-Gobain, Zweigniederlassung Deutschland v. Finanzamt Aachen-Innenstadt*, 1999 E.C.R. I-6161; Hans van den Hurk, *Is the Ability of the Member States To Conclude Tax Treaties Chained Up?*, 13 EC TAX REV. 17 (2004).

least for bilateral treaties between EU member states—one member state could not grant benefits to nationals of another member state without making similar benefits available to nationals of all member states.²³⁸ In allowing the German complainant benefits equivalent to those available to any Belgian national under the treaty, the Advocate General stated:

[A]ccepting reciprocal obligations to another member state which limit the freedom of movement of the nationals of European non-member countries is contrary to Community law. The fact must not be overlooked that national provisions, which include validly concluded and ratified international treaties, must not infringe the fundamental freedoms of the European legal system. . . .

. . . .

. . . I am aware of the dangers which the foregoing considerations imply for the equilibrium and reciprocity which prevail in the system of double-taxation treaties, *but those difficulties must not become obstacles to the establishment of the single market.* . . . [T]he States in question have a duty to seek other formulae which, whilst achieving the objective sought, do not, in breach of Community law, prejudice the citizens of other Member States.²³⁹

The ECJ reached a different conclusion.²⁴⁰ It upheld the Netherlands law allowing a wealth tax exemption only to its own residents on the ground that “the situation of a resident and that of a non-resident are as a rule not comparable.”²⁴¹ And—citing arguments by a number of member states that a contrary holding would entail “danger” and “legal uncertainty” for bilateral tax treaties—the court also found that the more favorable treatment granted by the Netherlands to a resident of Belgium under the bilateral treaty did not violate

238. Case C-376/03, *D. v. Inspecteur van de Belastingdienst* (Oct. 26, 2004) (opinion of Advocate General Colomer), <http://www.curia.eu.int/en/content/juris/index.htm> (search for “Case C-376/03”).

239. *Id.* ¶¶ 97, 101 (emphasis added).

240. Case C-376/03, *D. v. Inspecteur van de Belastingdienst*, 2005 ECJ CELEX LEXIS 349 (July 5, 2005); see also Case C-374/04, *Test Claimants v. Comm’rs of Inland Revenue* ¶¶ 97-103 (Feb. 23, 2006) (opinion of Advocate General Geelhoed), <http://www.curia.eu.int/en/content/juris/index.htm> (search for “Case C-374/04”) (declining to extend bilateral tax treaty benefits to third-country residents).

241. *Inspecteur van de Belastingdienst*, 2005 ECJ CELEX LEXIS ¶ 34.

EC law.²⁴² The court, however, did not override a prior precedent holding that a member state must extend bilateral income tax treaty benefits to a permanent establishment owned by nationals of a member state not a party to the treaty.²⁴³ Instead, its emphasis in the wealth tax case was on the reciprocal rights and obligations that are an “inherent consequence of bilateral double taxation conventions.”²⁴⁴

Given their conflicting conclusions, it is difficult to know what to make of the ECJ’s cases involving bilateral tax treaties. The court’s language suggests that the results will depend on whether the court concludes that the resident and nonresident are “in similar circumstances,” which seems quite fact specific. The court’s decision in the Netherlands wealth tax case suggests that it does not intend to impose a general most-favored-nation requirement on bilateral tax treaties, and it appears, for now at least, that the court will not lightly undermine even intra-European bilateral tax treaties.²⁴⁵ The great divergence between the opinions of the Advocate General and the court in this regard deserves emphasis, and the court’s decision has been strongly criticized by some advocates of European integration.²⁴⁶ The resulting uncertainty regarding bilateral tax treaties also makes it unclear whether the ECJ will uphold limitations on benefits clauses.

At a minimum, the United States must take into account potential interventions of the ECJ when negotiating bilateral tax treaties with EU member states. For the longer term, the United States should begin considering what kind of treaty it would be willing to negotiate with Europe as a whole.²⁴⁷ In the airline context, the United States went to considerable lengths to avoid a multilateral European treaty, principally to continue pressure on the British to expand landing rights at London’s Heathrow Airport. In the income tax context, given the wide variations in both tax rates and tax administrative capabilities among the twenty-five EU Member states, the United States should also move slowly, if at all, toward a one-size-fits-all European treaty. But over time that may be exactly what the ECJ’s jurisprudence will demand.

242. *Id.* ¶¶ 48, 63.

243. *Id.* ¶ 56 (citing Case C-307/97, *Compagnie de Saint-Gobain, Zweigniederlassung Deutschland v. Finanzamt Aachen-Innenstadt*, 1999 E.C.R. I-6161).

244. *Id.* ¶ 61.

245. See Marcel Buur, *ECJ Rejects ‘Most Favored Nation’ Argument in Dutch-German Tax Case*, *WORLDWIDE TAX DAILY*, July 7, 2005, 2005 WTD 129-2 (LEXIS).

246. See, e.g., van Thiel, *supra* note 169, at 455-57.

247. See Mason, *supra* note 229 (arguing for a multilateral tax treaty between the EU and the United States as a response to the ECJ decisions).

Finally – and perhaps most importantly – United States policymakers must begin to address how our nation should respond if, over time, the effect of the ECJ’s corporate tax jurisprudence is to dismantle corporate income taxes in Europe. The European retreat from shareholder-credit corporate tax integration has already had some impact on U.S. treaty negotiations with certain European partners and may have influenced the U.S. decision to pursue a dividend exclusion (or lower shareholder tax rate for dividends) rather than shareholder credits, although a 1992 Treasury Report recommending this course undoubtedly played a more important role.²⁴⁸

As we have discussed, one thread of the ECJ’s corporate tax decisions has struck down member state provisions designed to limit taxpayers’ ability to shift income from high- to low-tax member states. Here we have emphasized the court’s nullification in the *Lankhorst-Hohorst* case of Germany’s provision inhibiting earnings stripping by excessive interest deductions and the *Marks & Spencer* case, which requires the United Kingdom to allow foreign losses to offset domestic earnings. But a variety of other limitations are also in jeopardy. Many commentators believe, for example, that the ECJ is likely to find that widely used provisions limiting the ability of companies to use “controlled foreign corporations” to shift mobile income from higher- to lower-tax member states violate the free movement of capital or the freedom of establishment articles of the EC Treaty.²⁴⁹ Decisions like these threaten to make collecting corporate income taxes in Europe far more difficult.

There are a number of potential responses by the United States if Europe becomes a place where corporate income can easily escape tax.²⁵⁰ Some policymakers, concerned with the potential for U.S. corporations to shift manufacturing and other investments to Europe – policymakers principally interested in maintaining capital export neutrality – will urge provisions imposing greater U.S. income taxes on such investments. Other policymakers, concerned with maintaining the competitiveness of U.S. corporations doing

248. See U.S. DEP’T OF THE TREASURY, *supra* note 75. The United States currently taxes dividends at a fifteen percent rate. See I.R.C. § 1(h)(11) (West Supp. 2005). President Bush had proposed a one hundred percent exclusion for dividends from earnings on which corporate taxes had already been paid.

249. See *supra* note 102.

250. We have already seen something of the way the debate will unfold in the controversy over Treasury’s issuance of I.R.S. Notice 98-11, 1998-1 C.B. 433, which responded to certain tax planning techniques reducing corporate taxes in Europe. In that Notice, the IRS attacked transactions that reduced taxes of U.S. corporations in foreign countries. That unleashed an “explosion of criticism” attacking the Treasury and the IRS for attempting to use U.S. taxes as a “backstop” for “the tax systems of other countries.” See H. David Rosenbloom, *International Tax Arbitrage and the “International Tax System,”* 53 TAX L. REV. 137, 157 (2000).

business in Europe vis-à-vis European corporations operating there—policymakers principally interested in capital import neutrality—will not only resist any efforts to tighten U.S. taxes on foreign investments, but will also urge reductions in U.S. corporate income taxes in an effort to make investments in the United States more attractive.²⁵¹ Thus, the ECJ decisions raise the possibility of a United States-European race to the bottom in corporate income taxation. Should this occur, either government spending would have to be reduced or the lost revenues would have to be replaced by other taxes.

CONCLUSION

In an effort to advance economic and political integration in the EU, the European Court of Justice has decided numerous cases striking down provisions of member states' corporate income taxes. These decisions have been intended to promote the four freedoms guaranteed by the European treaties—the free movement of goods, services, labor, and capital—and to eliminate discrimination based on nationality. In the process, the court has developed a jurisprudence of nondiscrimination that goes beyond such requirements in international trade or tax treaties.

We have shown here that the ECJ's nondiscrimination jurisprudence reveals an impossible quest: to eliminate discrimination based on both the origin and destination of economic activity. We have also shown that this quest necessarily must fail in the absence of harmonized corporate income tax bases and rates among EU member states. This implies that the court will find it necessary somewhere along the way to retreat, creating not only legal uncertainty, but ultimately doctrinal incoherence.

At the same time, the ECJ's jurisprudence is restricting member states' flexibility over their own fiscal policies in a manner that conflicts sharply with the member states' retention of the power to veto any European income tax legislation. The constraints that the ECJ's view of nondiscrimination places on member states' abilities to use incentives to stimulate their own domestic economies makes it difficult for member states to use tax policy as a way to respond to recessions. This problem is most pressing for those member states

251. The discussion in the text assumes the continuing existence of a corporate income tax in the United States. Some analysts, however, have urged substituting some form of consumption tax for the current U.S. corporate income tax. PRESIDENT'S ADVISORY PANEL ON FED. TAX REFORM, SIMPLE, FAIR, AND PRO-GROWTH: PROPOSALS TO FIX AMERICA'S TAX SYSTEM 151-90 (2005). Such a development would, of course, put pressure on the Europeans either to protect or eliminate their own corporate income taxes.

that have joined the monetary union and have thereby given up their ability to use national monetary policy to combat recession.

We cannot predict where the dilemmas we have identified will lead. Europe, we think, has only two options: greater harmonization through coordination of income tax bases and rates, or greater restraint by the ECJ, either through its own decisionmaking or externally imposed by the member states. The resistance of a number of important member states to European harmonization is firm, and any harmonization of tax rates seems a long way off. So, in the near term at least, we expect the ECJ to become more restrained. Failing that, difficulties for the member states in fashioning their own tax policies will grow.

While it is tempting, from this side of the Atlantic, simply to watch these European developments with detachment, the United States's political and economic relationships with Europe are too extensive for our nation to remain unaffected. At a minimum, we would expect the ECJ's nondiscrimination jurisprudence concerning inbound investments to influence and ultimately enlarge the OECD and U.S. interpretations of related nondiscrimination provisions in income tax treaties. More fundamentally, the ECJ decisions render the future of bilateral treaties between the United States and EU member states uncertain. And if the U.S. Supreme Court were to become convinced that the ECJ's interpretations are appropriate for the United States, the Court might impose new constraints on the flexibility of our states to enact tax incentives promoting local investments.

Ultimately, if the ECJ continues along its current path, the ongoing ability of both EU member states and the United States to rely on corporate income taxes as an important source of government revenues could be threatened. Some would welcome such a development; others would abhor it. But none can deny that diminishing corporate revenues would put significant financial pressure on countries already strapped to finance government expenditures—expenditures that seem destined to grow as all our populations age.

Finally, nothing we have said here should be taken as reflecting opposition to greater federalization of Europe. We emphasize two points: First, the U.S. experience amply demonstrates that successful federalization does not demand the limitations on member states' taxing autonomy that the ECJ appears to be imposing. In particular, it is unnecessary to restrict member states' ability to use tax incentives to stimulate their domestic economies. Second, as we have shown, the tax decisions of the ECJ, spurred by the tax policy objectives of the European Commission, conflict directly with the member states' retention of veto power over issues of direct taxation. The draft European Constitution does not change this unanimity requirement, undoubtedly reflecting the view of at least some member states that retention of taxing authority is a crucial

aspect of their sovereignty. To be sure, greater federalization may require giving up this autonomy. If that is to occur, however, we believe that such change should come through democratic processes, with the critical decisions made by elected representatives rather than by appointed judges. This will require new European constitutional arrangements. When Europe reconsiders its constitutional arrangements, concerns like those we have expressed here will undoubtedly also emerge in legal contexts other than taxation.²⁵²

252. See, e.g., Thomas Ferenczi, *La Cour de justice est accusée d'outrepasser ses compétences*, LE MONDE, Jan. 13, 2006, at 8 (reporting the view of several member states that the ECJ had exceeded its judicial role in cases involving the role of women in the German army and the access of foreign students to Austrian universities).