

11-1-2008

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### Recommended Citation

Ruth Mason, *Made in America for European Tax: The Internal Consistency Test*, 49 B.C.L. Rev. 1277 (2008), <http://lawdigitalcommons.bc.edu/bclr/vol49/iss5/2>

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# MADE IN AMERICA FOR EUROPEAN TAX: THE INTERNAL CONSISTENCY TEST

RUTH MASON\*

**Abstract:** The European Court of Justice (“ECJ”) has come under increasing criticism for overstepping its institutional authority in tax cases by invalidating national tax regimes that are not discriminatory. This Article offers an explanation for the ECJ’s difficulties in tax cases. “Overlapping taxation”—the simultaneous exercise of tax jurisdiction by two states in cross-border tax cases—tends to create real, but nondiscriminatory, cross-border tax disadvantages that the ECJ may mistake for discrimination. When the ECJ mistakenly invalidates nondiscriminatory tax legislation, it encroaches on the tax sovereignty of the European Union member states and undermines their tax policy goals. To address this problem, this Article proposes that the ECJ adopt the “internal consistency test” in tax cases. Under this approach, developed by the U.S. Supreme Court to analyze state tax discrimination claims under the Dormant Commerce Clause, the ECJ would ask: If all twenty-seven member states enacted the challenged rule, would intra-Community commerce bear a burden that purely domestic commerce would not also bear? This Article shows how use of this test could reduce the risk of judicial error in tax cases, thereby deferring to member state tax autonomy while potentially fostering market integration.

## INTRODUCTION

There is no tax controversy more dramatic than that concerning what role the European Court of Justice should play in forming European tax policy. Only in the European Union (“EU”) have states with

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such a long history of independence ceded so much control over their tax systems to a central government. No other states have tolerated such extensive review of national tax laws by an international court. Though many states have agreed in trade treaties to substantive restrictions on their ability to impose *indirect* taxes on international commerce, states invariably carve out exceptions for direct tax measures,<sup>1</sup> and it is easy to see why: no state is willing to subject its income tax revenue stream, the very lifeblood of domestic policy, to external review.

Thus far, most of the influence exerted by the EU central government on member state income tax policy has been through review by the European Court of Justice ("ECJ" or the Court) of national tax laws for compatibility with the Treaty Establishing the European Community ("EC Treaty").<sup>2</sup> A member state discriminates in violation of the EC Treaty when it taxes cross-border economic activities<sup>3</sup> or cross-border income more than similar domestic activities or income.<sup>4</sup> For example, a member state would violate the EC Treaty if it subjected residents of other member states to higher tax rates than its own residents.<sup>5</sup> It would also violate the EC Treaty for a member state to deny to nonresidents tax benefits granted to similarly situated residents.<sup>6</sup> The EC

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<sup>1</sup> Alvin C. Warren, Jr., *Income Tax Discrimination Against International Commerce*, 54 *Tax L. Rev.* 131, 132-33 (2001). The Article concerns only direct taxes, *viz.*, those for which legal liability and economic burden fall on the same person. Direct taxes include personal income taxes; corporate income taxes are usually also considered under the rubric of direct taxes. Indirect taxes, whose economic burden is shifted from the person with the liability for remitting the tax to another person, include value-added taxes, and they are subject to extensive EC legislation. *See, e.g.*, Council Directive 2008/7/EC, art. 1, Concerning Indirect Taxes on the Raising of Capital, 2008 O.J. (L 46) 11 (EU); Council Directive 2006/112/EC, On the Common System of Value Added Tax, 2006 O.J. (L 347) 1 (EU).

<sup>2</sup> *See generally* Consolidated Version of the Treaty Establishing the European Community arts. 91-93, Mar. 25, 1997, 2002 O.J. (C 325) 33 [hereinafter EC Treaty].

<sup>3</sup> This Article uses the term "cross-border economic activities" to describe economic activities with connections to more than one EU member state—in other words, intra-Community commerce.

<sup>4</sup> *See* Case C-279/93, *Finanzamt Köln-Altstadt v. Schumacker*, 1995 E.C.R. I-225, ¶ 30 ("[D]iscrimination can arise only through the application of different rules to comparable situations or the application of the same rule to different situations."). *See generally* RUTH MASON, *PRIMER ON DIRECT TAXATION IN THE EUROPEAN UNION* (2005). The ECJ has accepted a limited number of public policy justifications for tax discrimination. *See id.* at 93-114.

<sup>5</sup> *See, e.g.*, Case C-311/97, *Royal Bank of Scot. plc v. Greece*, 1999 E.C.R. I-2651, ¶ 34 (holding that Greece discriminated when it taxed domestic banks at 35%, but branches of foreign banks at 40%).

<sup>6</sup> *See, e.g.*, *Schumacker*, 1995 E.C.R. I-225, ¶ 59 (holding that under certain circumstances, source states must allow nonresident taxpayers the same personal tax deductions as resident taxpayers).

Treaty forbids such tax discrimination because it hampers economic integration in Europe.<sup>7</sup>

Beginning with the first ECJ direct tax case in 1986, EU taxpayers have been overwhelmingly successful in their tax discrimination suits against EU member states,<sup>8</sup> and the revenue impact of ECJ tax cases has been significant.<sup>9</sup> A decision by the ECJ that a national tax provision violates the EC Treaty affects national budgets in three ways. First, the member state may no longer use the discriminatory provision to raise revenue, which means that to balance its budget it must either cut spending or increase the revenue raised by other taxes.<sup>10</sup> Second, decisions of the ECJ are generally retroactive, so that the member state is obliged to refund with interest any discriminatory taxes already collected.<sup>11</sup> Finally, the effect of a decision by the ECJ is not limited to the defendant member state.<sup>12</sup> The ECJ's interpretation of European

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<sup>7</sup> See EC Treaty arts. 2–3. See generally MASON, *supra* note 4.

<sup>8</sup> See generally Case 270/83, *Comm'n v. France (avoir fiscal)*, 1986 E.C.R. 273. Of the forty-nine direct tax discrimination cases decided between 1986 and the end of 2005, the defendant member state won in only nine cases (and in two of those cases the taxpayer also won some issues). See Case C-446/03, *Marks & Spencer plc v. Halsey*, 2005 E.C.R. I-10837, ¶ 59; Case C-512/03, *Blanckaert v. Inspecteur Van de Belastingdienst/Particulieren/Ondernemingen Buitenland te Heerlen*, 2005 E.C.R. I-7685, ¶ 51; Case C-376/03, *D. v. Inspecteur van de Belastingdienst*, 2005 E.C.R. I-5821, ¶ 63; Case C-403/03, *Schempp v. Finanzamt München*, 2005 E.C.R. I-642, ¶ 43; Case C-391/97, *Frans Gschwind v. Finanzamt Aachen-Außenstadt*, 1999 E.C.R. I-5451, ¶ 32; Case C-336/96, *Gilly v. Directeur des Services Fiscaux du Bas-Rhin*, 1998 E.C.R. I-2793, ¶¶ 53–54; Case C-250/95, *Futura Participations SA v. Administration des Contributions*, 1997 E.C.R. I-2471, ¶ 43; Case C-300/90, *Comm'n v. Belgium*, 1992 E.C.R. I-305, ¶ 24; Case C-204/90, *Hanns-Martin Bachmann v. Belgian State*, 1992 E.C.R. I-249, ¶ 35.

<sup>9</sup> For example, *Marks & Spencer* concerned tax losses of over \$200 million for a single U.K. corporate group. See *Marks & Spencer*, 2005 E.C.R. I-10837. In another recent case, the United Kingdom requested that the ECJ limit the temporal effects of its judgment, because settling claims arising from a British tax provision enacted in 1974 would cost the government an estimated £7 billion. Case C-446/04, *Test Claimants in the FII Group Litig. (Franked Investment Income)*, 2006 E.C.R. I-11753, ¶ 144 (opinion of Advocate General Geelhoed).

<sup>10</sup> See EC Treaty art. 228 (“If the Court of Justice finds that a Member State has failed to fulfill an obligation under this Treaty, the State shall be required to take the necessary measures to comply with the judgment of the Court of Justice.”).

<sup>11</sup> See, e.g., Case C-294/99, *Athinaiki Zithopiia AE (Athens Breweries) v. Greek State*, 2001 E.C.R. I-6769, ¶ 35; MASON, *supra* note 4, at 21.

<sup>12</sup> Although there is no formal doctrine of *stare decisis* in the ECJ, the procedural rules of the Court allow it to decide a preliminary ruling case by reasoned order rather than a formal opinion if resolution of the question “may be clearly deduced from existing case-law.” Codified Version of the Rules of Procedure of the Court of Justice of the European Communities, art. 104 § 3, 2001 O.J. (C 34) 1 [hereinafter *Rules of Procedure*]. Additionally, the Court cites its own precedent in subsequent cases. See, e.g., Case C-385/00, *De Groot v. Staatssecretaris van Financiën*, 2002 E.C.R. I-11819, ¶ 77. And member states with tax laws similar to those found by the ECJ to be inconsistent with EC law often amend

Community ("EC") law binds all the member states for that issue.<sup>13</sup> The budgetary impact of ECJ tax cases, as well as their centrality in defining the personal entitlements of EU nationals, makes it important for the ECJ to get its tax cases "right."

EU member states' willingness to continue to subject national income tax laws to review by the ECJ is uncertain. Member state tax administrators and tax academics have criticized the Court for overreaching in tax cases—particularly for finding discrimination where there was none.<sup>14</sup> The Court's tax jurisprudence is so controversial that during negotiations over the proposed European Constitution, member state representatives considered stripping the ECJ of jurisdiction over tax cases.<sup>15</sup> Although this drastic change did not survive in the final draft of the constitution, the member states are clearly sensitive to judicial incursions into this sacrosanct area of national sovereignty.

This Article explains why tax cases are especially challenging for the ECJ. International tax law recognizes the right of two different states to tax the same item of cross-border income.<sup>16</sup> The state in which the owner of the income resides (the "residence state") may tax the income, and the state where the income arises (the "source state") may also tax it. Such "overlapping taxation"<sup>17</sup> makes it difficult for the Court to identify tax discrimination because overlapping taxation causes "negative disparities," nondiscriminatory tax disadvantages that stem from differences in tax rates and definitions of taxable income

their laws without waiting for a separate challenge of their own law. See generally THE ACTE CLAIR IN EC DIRECT TAX LAW (Ana Paula Dourado & Ricardo da Palma Borges eds., 2008) (giving state-by-state analysis of the role of the *acte clair* doctrine in tax cases).

<sup>13</sup> See Rules of Procedure, *supra* note 12, art. 104 § 3.

<sup>14</sup> See, e.g., John F. Avery Jones, *Carry on Discriminating*, 6 BRIT. TAX REV. 525, 527 (1995); Michael J. Graetz & Alvin C. Warren, Jr., *Income Tax Discrimination and the Political and Economic Integration of Europe*, 115 YALE L.J. 1186, 1186 (2006); Luc Hinnekens, *European Court Goes for Robust Tax Principles for Treaty Freedoms. What About Reasonable Exceptions and Balances?*, 13 EC TAX REV. 65, 67 (2004); Ruth Mason, *U.S. Tax Treaty Policy and the European Court of Justice*, 59 TAX L. REV. 65, 89 (2005); Servaas van Thiel, *The Future of the Principle of Non-Discrimination in the EU: Towards a Right to Most Favored Nation Treatment and a Prohibition of Double Burdens?*, in COMPARATIVE FISCAL FEDERALISM 331, 399 (Reuven Avi-Yonah et al. eds., 2007); Peter J. Wattel, *Progressive Taxation of Nonresidents and Intra-EC Allocation of Personal Tax Allowances: Why Schumacker, Asscher, Gilly and Gschwind Do Not Suffice*, 40 EUR. TAX'N 210, 210 (2000); Dennis Weber, *In Search of a (New) Equilibrium Between Tax Sovereignty and the Freedom of Movement Within the EC*, 34 INTERTAX 585, 594 (2006).

<sup>15</sup> See Frans Vanistendael, *The ECJ at the Crossroads: Balancing Tax Sovereignty Against the Imperatives of the Single Market*, 2006 EUR. TAX'N 413, 413.

<sup>16</sup> See Peggy B. Musgrave, *Sovereignty, Entitlement, and Cooperation in International Taxation*, 26 BROOK. J. INT'L L. 1335, 1336–37, 1341–42 (2001).

<sup>17</sup> See *infra* notes 62–73 and accompanying text (distinguishing "overlapping taxation" from unrelieved "juridical double taxation").

between the source and residence states.<sup>18</sup> For example, a taxpayer from a low-tax state suffers a cross-border tax disadvantage by investing in a high-tax state. Such tax disparities are inevitable because national tax systems in the EU are not harmonized.<sup>19</sup> And because the EC Treaty does not require tax harmonization, the ECJ has held that tax disparities do not violate the EC Treaty, even when they discourage cross-border economic activity.<sup>20</sup>

Although the Court has held that tax disparities do not violate the EC Treaty because they are an unavoidable byproduct of retained tax autonomy, the Court has trouble distinguishing between tax disadvantages arising from disparities and tax disadvantages arising from discrimination.<sup>21</sup> When the ECJ mistakenly invalidates nondiscriminatory tax legislation, it unnecessarily constrains member states' tax policy decisions. These errors could ultimately jeopardize the ECJ's ability to review tax cases by pushing the member states to curtail the Court's direct tax jurisdiction.

But stripping the ECJ of its tax jurisdiction could compromise the European goal of economic integration. Because EU-level tax legislation requires the unanimous agreement of the twenty-seven member states, there is little EU tax legislation.<sup>22</sup> As a result, of all the EU institutions, the ECJ presently plays the most important role in promoting income tax cohesiveness in Europe by striking down national tax provisions that discriminate against intra-Community commerce. Reflecting the importance of this function, tax cases represent about ten percent of the ECJ's jurisprudence, and the number of tax cases decided by the Court each year is growing.<sup>23</sup> The role of the ECJ in tax cases can be seen as

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<sup>18</sup> See *infra* notes 80–98 and accompanying text.

<sup>19</sup> See, e.g., Case C-403/03, *Schempp v. Finanzamt München*, 2005 E.C.R. I-6421, ¶ 34.

<sup>20</sup> See, e.g., *id.*

<sup>21</sup> See *infra* notes 40–116 and accompanying text.

<sup>22</sup> See EC Treaty art. 93; MASON, *supra* note 4, at 9.

<sup>23</sup> See, e.g., COURT OF JUSTICE OF THE EUR. CMTYS., ANNUAL REPORT 2006, at 84 (2007). Annual statistics providing subject matter breakdowns of the ECJ's decisions show that taxation has consistently constituted about 10% of the Court's decisions since 1997, the first year for which statistics are available. See ANNUAL REPORT 2006, *supra*, at 84; COURT OF JUSTICE OF THE EUR. CMTYS., ANNUAL REPORT 2005, at 195 (2006); COURT OF JUSTICE OF THE EUR. CMTYS., ANNUAL REPORT 2004, at 171 (2005); COURT OF JUSTICE OF THE EUR. CMTYS., ANNUAL REPORT 2003, at 219 (2004); COURT OF JUSTICE OF THE EUR. CMTYS., ANNUAL REPORT 2002, at 159 (2003); COURT OF JUSTICE OF THE EUR. CMTYS., ANNUAL REPORT 2001, at 246 (2002); COURT OF JUSTICE OF THE EUR. CMTYS., ANNUAL REPORT 2000, at 244 (2001); COURT OF JUSTICE OF THE EUR. CMTYS., ANNUAL REPORT 1999, at 226 (2000); COURT OF JUSTICE OF THE EUR. CMTYS., ANNUAL REPORT 1998 (1999), at 189; ANNUAL REPORT OF THE COURT OF JUSTICE OF THE EUR. CMTYS. 1997, at 169 (1998). The number of tax cases decided each year has increased from twenty-eight decided tax cases in 1997 to fifty-one decided cases in 2006. See ANNUAL REPORT 2006, *supra*, at

analogous to that of the U.S. Supreme Court, which helped forge the American union by striking down discriminatory state taxes under the Dormant Commerce Clause.<sup>24</sup>

Although they recognize the importance of the role of the ECJ, commentators also understand that overlapping taxation creates difficulties in analyzing tax cases. To address these difficulties, commentators have offered—and the ECJ has sometimes adopted—the so-called “per-country” and “overall” approaches to resolving tax cases.<sup>25</sup> For reasons described at length in Part II, this Article rejects both of these standard approaches as inadequate to the challenges posed by an international tax setting in which more than one state taxes a single item of cross-border income.<sup>26</sup> Instead of these approaches, this Article offers a new analytical framework for tax discrimination cases.<sup>27</sup>

Because tax disparities arise from differences in the member states’ tax laws, there would be no tax disparities if the member states’ tax laws were harmonized. Therefore, when evaluating a national tax provision for compatibility with the EC Treaty under the internal consistency test proposed in this Article, the Court should first apply what I call the “harmony constraint,” under which it would assume that every member state applied the challenged tax rule.<sup>28</sup> If the relevant cross-border tax disadvantage remains after application of the harmony constraint, the Court can safely conclude that the disadvantage was not caused by disparities, and it should closely scrutinize the law for discrimination. Thus, rather than positively identifying discrimination, the main virtue of the internal consistency test is that it provides a reliable way to rule out the possibility that a disparity caused the tax disadvantage. By filtering out disparities, internal consistency could help the Court avoid infringing member state tax autonomy by reducing the likelihood that the ECJ would invalidate disparate, but nondiscriminatory, legislation. Although this approach would be new for Europe, the

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84; ANNUAL REPORT 1997, *supra*, at 169. The Annual Reports do not indicate how many of these cases were direct tax discrimination cases. See, e.g., ANNUAL REPORT 2006, *supra*, at 84. But see European Commission, *ECJ (and CFI) Cases in the Field of, or of Particular Interest for, Direct Taxation (Capital Duty Inclusive)* (Eur. Commission, Brussels, Belg.), August 28, 2008, at 6–8 available at [http://ec.europa.eu/taxation\\_customs/resources/documents/common/infringements/case\\_law/court\\_cases\\_direct\\_taxation\\_en.pdf](http://ec.europa.eu/taxation_customs/resources/documents/common/infringements/case_law/court_cases_direct_taxation_en.pdf) (showing only thirty-three direct tax cases decided in 2006, thus suggesting that the remainder involved indirect taxation).

<sup>24</sup> See *infra* notes 176–177 and accompanying text.

<sup>25</sup> See *infra* notes 122–145 and accompanying text.

<sup>26</sup> See *infra* notes 122–161 and accompanying text.

<sup>27</sup> See *infra* notes 162–198 and accompanying text.

<sup>28</sup> See *infra* notes 162–189 and accompanying text.

U.S. Supreme Court has employed a similar approach since the 1980s in state tax discrimination cases arising under the Dormant Commerce Clause.<sup>29</sup> When the U.S. Supreme Court applies the internal consistency test, it asks: if all 50 states enacted the challenged rule, would interstate commerce bear a burden that purely domestic commerce would not also bear?<sup>30</sup>

Although the ECJ and tax commentators usually define disparities to include only cross-border tax disadvantages, unharmonized tax systems also result in cross-border advantages, or what I call "positive disparities." For example, a taxpayer from a high-tax state who invests in a low-tax state may gain a tax advantage on cross-border investment that is not available for domestic investment.<sup>31</sup> In cases where disparities between the tax laws of the source and residence states result in a net cross-border tax advantage, the advantage could obscure the fact that one of the states actually discriminated against the taxpayer. The Court's failure to recognize such tax discrimination compromises the economic integration of the common market as well as the personal economic freedoms of EU nationals.<sup>32</sup> By eliminating positive tax disparities, the internal consistency test could also help the Court in cases where compensatory tax advantages offered by one state obscure discrimination by another.<sup>33</sup>

The internal consistency test also would simplify a notoriously complex<sup>34</sup> area of EC law by converting the tax discrimination question from one potentially involving twenty-seven member states to one involving only a single state: the defendant. If every member state applied the same tax law as the defendant state, the ECJ would never have to

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<sup>29</sup> See generally Walter Hellerstein, *Is "Internal Consistency" Dead?: Reflections on an Evolving Commerce Clause Restraint on State Taxation*, 61 TAX L. REV. 1 (2007) [hereinafter Hellerstein, *Internal Consistency II*]; 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 I*].

<sup>30</sup> See, e.g., *Okla. Tax Comm'n v. Jefferson Lines, Inc.*, 514 U.S. 175, 185 (1995) (upholding Oklahoma's sales tax on the full price of tickets for interstate bus travel because if every state enacted such a law, then interstate bus tickets would be taxed only once, in the state of purchase).

<sup>31</sup> See *infra* notes 80–98 and accompanying text.

<sup>32</sup> See *infra* notes 80–98 and accompanying text.

<sup>33</sup> See *infra* notes 99–116 and accompanying text.

<sup>34</sup> Case C-374/04, *Test Claimants v. Comm'rs of Inland Revenue*, 2006 E.C.R. I-11673, ¶ 3 (opinion of Advocate General Geelhoed) ("This is an area in which the Court, faced with increasingly complicated factual and legislative contexts and arguments seeking to test the limits of the Treaty, has developed a substantial body of rather complex case-law.").



inquire into the tax laws of any state other than the one before the Court.

Part I of this Article briefly presents the ECJ's conception of tax discrimination and shows how overlapping taxation obscures tax discrimination.<sup>35</sup> Part II argues that the overlapping tax dilemma cannot be resolved by application of the per-country or overall approaches.<sup>36</sup> Part III presents the internal consistency test, shows how it would work in the EU context, and describes the benefits that could be expected if the ECJ adopted it.<sup>37</sup> Part III also discusses how differences between U.S. state taxation and EU member state taxation would make the approach even more useful in the EU context than in the U.S. context.<sup>38</sup> Finally, Part IV anticipates and addresses some potential objections to the internal consistency test.<sup>39</sup>

## I. THE OVERLAPPING TAX DILEMMA

### A. *Tax Discrimination Under EC Law*

The requirement of unanimous agreement among the twenty-seven member states for tax legislation at the EU level presents a nearly insurmountable bar to EU-wide tax legislation.<sup>40</sup> As a result, of all the EU institutions, the ECJ has exerted the greatest influence on direct taxation. The ECJ hears direct tax cases primarily as references for preliminary ruling, in which national courts refer to the ECJ questions concerning the compatibility of member state tax laws with EC law.<sup>41</sup> In the two decades during which it has decided direct tax cases, the ECJ has developed robust tax nondiscrimination principles.<sup>42</sup> Under these principles, member states may not use their tax systems to discriminate against EU nationals (including companies) exercising their right to freedom of movement of goods, services, workers, or capital across

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<sup>35</sup> See *infra* notes 40–121 and accompanying text.

<sup>36</sup> See *infra* notes 122–161 and accompanying text.

<sup>37</sup> See *infra* notes 162–198 and accompanying text.

<sup>38</sup> See *infra* notes 189–198 and accompanying text.

<sup>39</sup> See *infra* notes 199–230 and accompanying text.

<sup>40</sup> See EC Treaty art. 93.

<sup>41</sup> See *id.* art. 234. Of the thirty-four new tax cases listed in the 2006 Annual Report, twenty-seven were references for a preliminary ruling while only seven were direct actions. See ANNUAL REPORT 2006, *supra* note 23, at 90. Thus, private litigation by EU taxpayers in national courts, followed by references by those national courts to the ECJ, has been an important mechanism for enforcing the EC Treaty's prohibition on tax discrimination.

<sup>42</sup> See *infra* notes 122–160 and accompanying text.

member state borders.<sup>43</sup> Nor may member states create obstacles that prevent EU nationals from conducting or establishing business across member state borders.<sup>44</sup>

Before one considers the overlapping tax dilemma, it is useful to understand the Court's conception of tax discrimination. The Court has interpreted the EC Treaty to forbid a member state from treating a taxpayer resident in another member state worse for tax purposes than a similarly situated resident taxpayer.<sup>45</sup> Impermissible tax discrimination takes a variety of forms: a state might charge nonresident taxpayers a higher tax rate than residents on the same economic activity;<sup>46</sup> or a state could subject nonresidents to a higher tax base than residents.<sup>47</sup> Likewise, a state might subject nonresidents to more onerous tax administrative procedures than residents<sup>48</sup> or deny nonresidents interest on tax refunds when interest would be paid to residents.<sup>49</sup> Alternatively,

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<sup>43</sup> See EC Treaty art. 12 (prohibiting nationality discrimination); *id.* arts. 23–32, 39, 49, 56 (barring cross-border restraints on movement of goods, workers, services, and capital).

<sup>44</sup> See *id.* art. 43 (prohibiting restraints on cross-border business establishment). For purposes of the EC Treaty, companies are considered to have the nationality of the member state of their corporate seat. See *id.* art. 48.

<sup>45</sup> Case C-279/93, *Finanzamt Köln-Alstadt v. Schumacker*, 1995 E.C.R. I-225, ¶ 30. According to the ECJ, a member state engages in tax discrimination when it applies "different rules to comparable situations" or "the same rule to different situations." *Id.* Thus, if the ECJ determines that a cross-border taxpayer is "similarly situated" to a domestic taxpayer, the two taxpayers may not be treated differently for tax purposes. See Ruth Mason, *Flunking the ECJ's Tax Discrimination Test*, 46 COLUM. J. TRANSNAT'L L. 72, 77, 92–95 (2008) (arguing that the ECJ's explanations for its decisions present no clear conception of tax discrimination, but arguing that the outcomes of its cases could be understood to mean that the Court considers, at a minimum, both protectionist taxes and taxes that create restrictions on outbound activities to violate the EC Treaty). The EC Treaty also prohibits member states from "restricting" EU nationals' free movement rights, but the Court's tax restriction jurisprudence is still undeveloped at this point, and it is not clear what restriction analysis would add to the Court's already robust notion of nondiscrimination. See *infra* notes 122–160 and accompanying text.

<sup>46</sup> See Case C-311/97, *Royal Bank of Scot. plc v. Greece*, 1999 E.C.R. I-2651, ¶ 34.

<sup>47</sup> See Case C-234/01, *Gerritse v. Finanzamt Neukölln-Nord*, 2003 E.C.R. I-5933, ¶ 55 (holding that a member state could not tax nonresidents on a gross basis when it taxed similarly situated residents on a net basis, at least in cases where gross basis taxation would lead to higher taxes than net basis taxation).

<sup>48</sup> See Case C-175/88, *Biehl v. Administration des Contributions de Luxembourg*, 1990 E.C.R. I-1779, ¶¶ 18–19 (finding EC Treaty violation where full-year residents were entitled to automatic tax refunds, whereas partial-year residents first had to participate in an administrative procedure).

<sup>49</sup> See Case C-330/91, *Queen v. Inland Revenue Comm'rs ex parte Commerzbank AG*, 1993 E.C.R. I-4017, ¶ 20 (finding EC Treaty violation where residents, but not nonresidents, were entitled to interest on tax refunds).

a state may violate the EC Treaty by granting tax advantages to residents while denying them to nonresidents.<sup>50</sup>

In addition to preventing host states from discriminating against nonresidents, the Court has also interpreted the EC Treaty to prevent a member state from penalizing its own residents' cross-border income and economic activity in comparison with their domestic income and activity.<sup>51</sup> For example, a member state may not tax dividends received from companies established in fellow member states more harshly than domestic dividends.<sup>52</sup> Thus, for EC law purposes, discriminatory taxes include both those that treat taxpayers worse because they are non-nationals or nonresidents and those that single out cross-border income for harsher taxation than domestic income.<sup>53</sup>

Nevertheless, not all cross-border tax disadvantages amount to discrimination.<sup>54</sup> If they did, the nondiscrimination requirement would be a de facto tax harmonization requirement. For example, if the ECJ were to hold that every cross-border tax disadvantage violates the EC Treaty, then no member state could have a tax rate higher than that of the member state with lowest rate. Any rate divergence would mean that residents of the lowest-tax state would experience cross-border tax disadvantages, and therefore discrimination, whenever they invested or did business in another state. Such a broad conception of tax discrimination would leave no room for variation among member state tax systems, and it would invade the member states' reserved autonomy to determine their tax base, tax rates, and rules for asserting tax jurisdiction.<sup>55</sup>

The Court refers to cross-border tax disadvantages arising from unharmonized tax systems as "disparities," and it has explicitly declared

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<sup>50</sup> See, e.g., Case C-264/96, *Imperial Chem. Indus. plc v. Colmer*, 1998 E.C.R. I-4695, ¶ 30 (holding that denial of group loss relief based on corporate residence violated the EC Treaty); Case C-270/83, *Comm'n v. France (avoir fiscal)*, 1986 E.C.R. 273, ¶ 55 (holding that denial of imputation credits based on corporate residence violated the EC Treaty).

<sup>51</sup> See Case C-315/02, *Lenz v. Finanzlandesdirektion für Tirol*, 2004 E.C.R. I-7063, ¶ 49.

<sup>52</sup> See *id.*

<sup>53</sup> See *id.*; *Gerritse*, 2003 E.C.R. I-5933, ¶ 55; *Royal Bank of Scot.*, 1999 E.C.R. I-2651, ¶ 34; *Commerzbank*, 1993 E.C.R. I-4017, ¶ 20; *Biehl*, 1990 E.C.R. I-1779, ¶¶ 18-19.

<sup>54</sup> See, e.g., Case C-403/03, *Schempp v. Finanzamt München*, 2005 E.C.R. I-6421, ¶ 34 (finding no discrimination, despite the fact that alimony payments made to recipients resident in other member states could be subject to higher taxes in Germany than payments to German recipients).

<sup>55</sup> The Court has acknowledged this reserved autonomy. See, e.g., Case C-446/04, *Test Claimants in the FII Group Litig. (Franked Investment Income)*, 2006 E.C.R. I-11753, ¶ 35 ("[D]irect taxation falls within [member states'] competence . . ."); *Schumacker*, 1995 E.C.R. I-225, ¶ 21 ("[A]s Community law stands at present, direct taxation does not as such fall within the purview of the Community.").

that disparities do not violate the nondiscrimination principle.<sup>56</sup> The concept of disparities is explored more fully in Subpart C of this Part,<sup>57</sup> but, at the outset of the discussion, it is useful to emphasize that rather than condemning all cross-border tax disadvantages, the ECJ focuses instead on cases in which the member state targets cross-border activity for harsher tax treatment than similar domestic activities.<sup>58</sup> A convenient way to think about the tax nondiscrimination principle in the European Union is that it demands horizontal equity in the cross-border context, but says nothing about vertical equity.<sup>59</sup> Member states make autonomous vertical equity judgments about tax rates, degrees of progressivity, personal exemptions, and so on,<sup>60</sup> but, once such judgments are made, member states may be required to apply them with equal force to both internal and cross-border situations.<sup>61</sup>

### B. Distinguishing Overlapping Taxation from Double Taxation

In order to understand the difficulties overlapping taxation creates for the Court, one first needs to understand what overlapping taxation is and how it differs from the more commonly understood concept of “double taxation.” For purposes of this Article, the term “overlapping taxation” describes situations in which two or more states concurrently exercise jurisdiction to tax a single item of income. For example, suppose Smith resides in the United Kingdom and works in the Netherlands. For tax purposes, the United Kingdom is Smith’s residence state,

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<sup>56</sup> See, e.g., *Schempp*, 2005 E.C.R. I-6421, ¶ 34 (noting that the EC Treaty prohibition on discrimination “is not concerned with any disparities in treatment . . . which may result from divergences existing between the various member states, so long as they affect all persons subject to them in accordance with objective criteria and without regard to their nationality”); Case C-336/96, *Gilly v. Directeur des Services Fiscaux du Bas-Rhin*, 1998 E.C.R. I-2793, ¶¶ 49, 53 (holding that a tax “disparity” resulting from differences between the nondiscriminatory tax laws of two member states did not violate the EC Treaty).

<sup>57</sup> See *infra* notes 74–116 and accompanying text.

<sup>58</sup> See *infra* notes 74–116 and accompanying text.

<sup>59</sup> See, e.g., *Schumacker*, 1995 E.C.R. I-225, ¶¶ 24, 30. Horizontal equity is the notion that similarly situated taxpayers should be treated the same. See LIAM MURPHY & THOMAS NAGEL, *THE MYTH OF OWNERSHIP: TAXES AND JUSTICE* 37–39 (2002). Vertical equity refers to the notion that there may be reasons to treat taxpayers at different income levels differently—for example, a state may conclude that higher income taxpayers should pay more tax as a proportion of their income than do lower income taxpayers. See *id.* at 13.

<sup>60</sup> See *Gilly*, 1998 E.C.R. I-2793, ¶¶ 49, 53 (holding that a cross-border disadvantage due to differences in national tax rates was not discriminatory).

<sup>61</sup> The ECJ often articulates the nondiscrimination standard as one that requires similar treatment for similar taxpayers. See, e.g., *Schumacker*, 1995 E.C.R. I-225, ¶¶ 24, 30. For horizontal and vertical equity considerations in tax policy, see MURPHY & NAGEL, *supra* note 59, at 12–39.

and the Netherlands the source of her income.<sup>62</sup> As her residence state, the United Kingdom asserts an unlimited right to tax Smith's income wherever derived. The broad tax claim of states acting in a residence capacity derives from protections and privileges they extend to their residents at home and abroad, as well as any benefits provided, including education, that enhance residents' ability to earn income abroad.<sup>63</sup> The Netherlands, as the source state, also claims a right to tax Smith because it provided conditions that enabled her to earn income within its borders, including natural resources, infrastructure, labor and capital markets, and so on.<sup>64</sup> The source state's jurisdiction to tax is limited to income earned within its territory.<sup>65</sup>

Because both the residence and source states have the right to tax, overlapping taxation is commonplace in cross-border situations. To prevent cross-border taxpayers from suffering "juridical double taxation,"<sup>66</sup> most residence states relieve double taxation unilaterally. Additionally, states may undertake reciprocal double tax relief obligations in bilateral tax treaties.

In some cases, the tax treaty between the source state and the residence state solves the overlapping tax problem by assigning exclusive tax rights to one state.<sup>67</sup> Tax treaties, however, usually do not assign exclusive taxing rights.<sup>68</sup> Instead, in most cases, they provide that both states will exercise limited, but nevertheless concurrent, tax ju-

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<sup>62</sup> Residence for tax purposes is based on a personal connection to the state, such as domicile or length of physical presence. See HUGH J. AULT & BRIAN J. ARNOLD, *COMPARATIVE INCOME TAXATION: A STRUCTURAL ANALYSIS* 347 (2d ed. 2004). The United States is unique in taxing on the basis of citizenship, even when its citizens physically reside outside of the United States. See *id.* Corporate tax residence is usually based on place of incorporation or place of management and control. See *id.* at 347-50. For discussion of the normative justifications for source- and residence-based taxation, see generally Nancy H. Kaufman, *Fairness and the Taxation of International Income*, 29 *LAW & POL'Y INT'L BUS.* 145 (1998).

<sup>63</sup> See Musgrave, *supra* note 16, at 1336-37; see also Michael J. Graetz & Michael M. O'Hear, *The "Original Intent" of U.S. International Taxation*, 46 *DUKE L.J.* 1021, 1033-41 (1997).

<sup>64</sup> See Musgrave, *supra* note 16, at 1341-42.

<sup>65</sup> See *id.*

<sup>66</sup> This Article uses the terms "juridical double taxation" or "double taxation" to refer to "international juridical double taxation," which the Organization for Economic Cooperation and Development ("OECD") defines as "the imposition of comparable taxes in two (or more) States on the same taxpayer in respect of the same subject matter and for identical periods." OECD, *MODEL TAX CONVENTION ON INCOME AND CAPITAL* ¶ 1, at 7, (7th ed., condensed version 2008) [hereinafter OECD MODEL].

<sup>67</sup> See, e.g., *id.* art. 7(1), at 26. Under article 7 of the OECD Model Treaty, if an enterprise residing in one state (the residence state) has activities in the other state (the source state), the source state may not tax the profits from those activities, unless the enterprise has sufficient activities in the source state to constitute a "permanent establishment." See *id.*

<sup>68</sup> See, e.g., *id.* art. 10, at 28-29.

risdiction.<sup>69</sup> In effect, the states share the tax revenue generated by the cross-border income, with each state taxing the income less than it would in a purely domestic situation.<sup>70</sup>

Thus, although the two concepts are easily conflated, overlapping jurisdiction to tax is not the same as unrelieved double taxation.<sup>71</sup> Although overlapping tax jurisdiction creates the risk of unrelieved double taxation, it does not inevitably result in such double taxation. The net result of overlapping taxation could be higher, lower, or the same amount of tax as would be paid in a purely domestic situation.<sup>72</sup> Even where double taxation (i.e., higher taxation) has been successfully eliminated unilaterally or through bilateral tax treaties, overlapping taxation usually persists, and, to the extent that the existence of overlapping taxation creates difficulties for the ECJ in resolving tax cases, those difficulties also persist.<sup>73</sup>

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<sup>69</sup> For example, under article 10 of the OECD Model Treaty, the source state must limit its taxation of portfolio dividends to fifteen percent of the gross amount of the dividend paid by a company residing in its territory to a taxpayer resident in the other party to the tax treaty. *Id.* But the residence state may also tax the same dividend. *Id.* art. 10(2)(b). Although article 23 provides that the residence state will relieve any resulting double taxation, concurrent exercise of tax jurisdiction persists despite the presence of the treaty and despite the obligation to relieve double taxation. *Id.* arts. 10, 23, at 28–29, 35–36.

<sup>70</sup> See Warren, *supra* note 1, at 132 (describing the traditional division of the tax base between the source and residence states as “a principal function, perhaps *the* principal function, of the international income tax system” (citation omitted)).

<sup>71</sup> Among tax lawyers, the term “double taxation” is almost synonymous with higher taxation, and it constitutes such a clear source of impediments to cross-border economic activity that, as early as 1899, Prussia and Austria entered into the first tax treaty to prevent it. See ZVI DANIEL ALTMAN, *DISPUTE RESOLUTION UNDER TAX TREATIES* 13 (2005). The 200 pages of commentary to the OECD Model Treaty begin with the following statement of purpose:

[Double taxation’s] harmful effects on the exchange of goods and services and movements of capital, technology, and persons are so well known that it is scarcely necessary to stress the importance of removing obstacles that double taxation presents to the development of economic relations between countries.

OECD, *Introduction to the OECD Model Tax Convention and Commentary* ¶ 1 (2005), reprinted in 1 *MATERIALS ON INTERNATIONAL AND EC TAX LAW* 45 (Kees van Raad ed., 6th ed. 2006). In contrast, I use the term “overlapping taxation” to describe a common cross-border situation in which two countries tax the same item of income.

<sup>72</sup> Lower taxation would result if one state did not exercise its full taxing jurisdiction because it anticipated that the other would do so, but the other state did not fully tax. Lower taxation could also result if one state perceived itself to have a double tax relief obligation, even though the other state had not fully taxed the item of income.

<sup>73</sup> See *infra* note 81–132 and accompanying text.

### C. Tax Disparities

The next fundamental issue concerns the nature of the difficulties created for the ECJ by overlapping tax jurisdiction. According to the Court, the member states remain free to set their own tax rates, tax bases, and rules for allocating among themselves jurisdiction to tax international income.<sup>74</sup> These retained powers enable the states to formulate tax policy independently of each other and to meet their individual revenue needs. The simultaneous application of uncoordinated tax laws by two states, however, may result in tax disparities, which the Court defines as differences between the tax treatment of cross-border and domestic situations that arise from unharmonized member state tax systems.<sup>75</sup>

In recognition of member state tax autonomy, the ECJ acknowledges that disparities do not violate the prohibition on discriminatory taxation,<sup>76</sup> and the Court has declared that the EC Treaty provides no guarantee to EU taxpayers that their decision to engage in cross-border economic activities will be tax neutral.<sup>77</sup> Nevertheless, when a tax disparity results in a net tax disadvantage to the taxpayer, the Court may erroneously conclude that there was discrimination.<sup>78</sup> Additionally, when a tax disparity results in a net tax advantage, the advantage may obscure the fact that one of the states actually discriminated in violation of the EC Treaty.<sup>79</sup>

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<sup>74</sup> See, e.g., *Franked Investment Income*, 2006 E.C.R. I-11753, ¶ 52 (“[I]n the absence of any unifying or harmonizing Community measures, member states retain the power to define, by treaty or unilaterally, the criteria for allocating their powers of taxation, particularly with a view to eliminating double taxation.”).

<sup>75</sup> See, e.g., *Schempp*, 2005 E.C.R. I-6421, ¶ 34 (“It is settled case-law that Article 12 EC is not concerned with any disparities in treatment, for persons and undertakings subject to the jurisdiction of the Community, which may result from divergences existing between the various Member States, so long as they affect all persons subject to them in accordance with objective criteria and without regard to their nationality.” (citation omitted)).

<sup>76</sup> See *supra* note 56 and accompanying text. It is possible that disparities between member states’ laws, although nondiscriminatory, could so hamper cross-border movements that the Court would consider them to violate the EC Treaty as “restrictions.” See *infra* notes 199–210 and accompanying text (considering how adoption by the ECJ of a “restriction” approach in tax cases would impact the proposal made in this Article).

<sup>77</sup> Cf. Case C-365/02, *In re Lindfors*, 2004 E.C.R. I-7183, ¶ 34 (“The EC Treaty offers no guarantee to a citizen of the Union that transferring his activities to a Member State other than that in which he previously resided will be neutral as regards taxation. Given the disparities in the tax legislation of the Member States, such a transfer may be to the citizen’s advantage in terms of indirect taxation or not, according to circumstance.”).

<sup>78</sup> See *infra* notes 80–98 and accompanying text.

<sup>79</sup> See *infra* notes 99–116 and accompanying text.

## 1. When Higher Taxes Do Not Discriminate

A higher tax bill alone is not proof of discrimination.<sup>80</sup> The EC Treaty only protects EU nationals from discriminatory taxes—those that use the taxpayer's nationality, residence, or foreign-source income as a basis for less favorable taxation compared to that applied in a similar domestic situation. Disparities may, however, create *nondiscriminatory* cross-border tax disadvantages that the Court erroneously perceives to be discriminatory.

Consideration of disparate tax rates shows why disparities do not constitute nationality discrimination, even when they create cross-border tax disadvantages. Suppose there are two member states: High and Low. High taxes all income at a rate of 50%, while Low taxes all income at a rate of 25%. If Mary resides in Low, but invests in High, she will pay higher taxes on her cross-border investment than she would on an equivalent domestic investment in Low. Mary therefore suffers a cross-border tax disadvantage. High does not discriminate against her, however, as long as it taxes her at the same rate as it would have taxed one of its own residents. To preserve the member states' autonomy to set tax rates, the Court has accepted cross-border tax disadvantages caused by differences in tax rates.<sup>81</sup> In contrast, discrimination occurs when a member state singles out cross-border taxpayers or cross-border activities for worse tax treatment.<sup>82</sup> For example, High would discriminate if it taxed Mary at a rate of 60% while taxing its own residents at only 50%.<sup>83</sup>

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<sup>80</sup> See, e.g., *Gilly*, 1998 E.C.R. I-2793, ¶¶ 34, 48; cf. *In re Lindfors*, 2004 E.C.R. I-7183, ¶ 34.

<sup>81</sup> See *Gilly*, 1998 E.C.R. I-2793, ¶¶ 34, 48 (holding that a cross-border tax disadvantage caused by the resident state's foreign tax credit limitation did not violate the EC Treaty because the disadvantage was caused by divergent "scales of direct taxation" and to require the resident state to "reduce its tax in respect of the remaining income . . . would . . . encroach on its sovereignty in matters of direct taxation").

Advocate General Léger noted that the ECJ lacks the power to eliminate disparities: "[I]n the absence of Community harmonisation it must be accepted that there is competition between the tax regimes of the various Member States." *Case C-196/04, Cadbury Schweppes plc v. Comm'rs of Inland Revenue*, 2006 E.C.R. I-7995, ¶ 55 (opinion of Advocate General Léger); see also *Case C-374/04, Test Claimants v. Comm'rs of Inland Revenue*, 2006 E.C.R. I-11673, ¶¶ 37-39 (opinion of Advocate General Geelhoed) (concluding that disparity cases are nonjusticiable).

<sup>82</sup> Nationality and state of tax residence tend to overlap; therefore, the Court scrutinizes tax classifications based on residence because such classifications may indirectly discriminate on the basis of nationality. See, e.g., *Schumacher*, 1995 E.C.R. I-225, ¶¶ 27-29.

<sup>83</sup> See *Royal Bank of Scot.*, 1997 E.C.R. I-2651, ¶ 34 (holding that Greece discriminated when it taxed domestic banks at 35% but branches of foreign banks at 40%).



Like tax rates, tax base definitions vary considerably from state to state.<sup>84</sup> These differences derive from divergent tax policy decisions by the member states. Consider the taxation of alimony. Some states tax alimony as income to the recipient. To ensure that alimony income will be taxed at least once, but not more than once, between the former spouses, such states allow the alimony payer to deduct it. But the same result—a single tax on the alimony—could be achieved by including the alimony in the payer's income (by denying the deduction), and excluding the alimony from the income of the recipient. The first method makes the recipient taxable on the alimony, while the second method makes the payer taxable. The choice between the two is a matter of national tax policy.

Germany employs the first method, but Austria employs the second.<sup>85</sup> The disparity in the treatment of alimony between Germany and Austria could lead to a cross-border disadvantage if the alimony payer lives in Austria, and the recipient in Germany. In that case, *both* the payer and the recipient may be taxed on the alimony.<sup>86</sup> Although this result would be harsh, neither state would have committed nationality discrimination because neither state singled out cross-border alimony payments for worse tax treatment than that applicable to domestic alimony payments. Instead, the cross-border tax disadvantage resulted from the mismatch of the German and Austrian tax systems; it is a disparity.<sup>87</sup>

Notice that differences in national tax rules may also result in cross-border tax advantages. When Mary, who resides in Low, invests in High, she suffers a cross-border tax disadvantage. A resident of High who invests in Low, however, would secure a cross-border tax advantage from the differences in national tax rates. Similarly, although an Austrian alimony payer and a German alimony recipient both may pay tax on the same cross-border alimony payment, if the payer lives in Germany and the recipient in Austria, neither may pay tax on the alimony.<sup>88</sup> The first case might seem too harsh and the second case too

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<sup>84</sup> See, e.g., *Schempp*, 2005 E.C.R. I-6421, ¶¶ 42–48.

<sup>85</sup> See *id.* (involving cross-border alimony payments from Germany to Austria). The United States taxes the recipient on alimony, and it allows the payer a deduction. See I.R.C. §§ 61, 71 (2000).

<sup>86</sup> See *Schempp*, 2005 E.C.R. I-6421.

<sup>87</sup> See *id.*

<sup>88</sup> The payer would get a deduction in Germany, but the Austrian recipient would not have to include the alimony in income. Cf. *id.* ¶ 5. This example assumes that the payer's deduction would not be conditioned upon the recipient's inclusion of the payment in income. This assumption is contrary to fact in the case of Germany. See *id.*; cf. Lunding v.

generous, but the unfairness stems from the mismatch of the German and Austrian tax systems, not discrimination.<sup>89</sup> These features are common to all tax disparities: (1) they may create disadvantages or advantages for cross-border situations, and (2) no particular state can be said to be at fault for the disadvantage or advantage.

Because it can be difficult to distinguish cross-border tax disadvantages caused by disparities from cross-border tax disadvantages caused by discrimination, however, the ECJ may incorrectly hold merely disparate tax laws to be discriminatory.<sup>90</sup> Such judicial errors infringe member state tax autonomy, unnecessarily narrow member states' tax policy options, and make it more difficult for member states to raise sufficient tax revenue to fund their social programs.<sup>91</sup> To the extent that member state tax laws represent the political will of the state's population, the Court's erroneous invalidation of tax laws also exacerbates the anti-majoritarian difficulty.<sup>92</sup> Thus, the ECJ is sometimes perceived as supplanting the role of national legislatures in making tax policy although it lacks both a democratic mandate and tax expertise.<sup>93</sup>

On the other hand, judicial overreaching in the tax area promotes tax harmonization, which could lower compliance costs, reduce distortions of decisions by EU taxpayers concerning where to locate eco-

N.Y. Tax Appeals Tribunal, 522 U.S. 287, 314–15 (1998) (involving an alimony deduction allowed by the state of New York to resident payers without a requirement that an out-of-state recipient be subject to tax on the alimony).

<sup>89</sup> It is possible that disparities between member states' laws, although nondiscriminatory, could so hamper cross-border movements that the Court would consider them to violate the EC Treaty as "restrictions." See *infra* notes 199–210 and accompanying text.

<sup>90</sup> Arguably, this was the case in *De Groot*. See Case C-385/00, *De Groot v. Staatssecretaris van Financiën*, 2002 E.C.R. I-11819, ¶ 110 (holding that a member state discriminated against a resident taxpayer when it denied personal tax relief in proportion to the resident's exempt foreign-source income). The Court based its holding in part on reliance on the fact that the host states in which the taxpayer earned his foreign income would not provide the taxpayer with personal tax relief, even though they taxed him on his income sourced within their territory. See *id.*; see also *Wattel*, *supra* note 14, at 213.

<sup>91</sup> This effect may be exacerbated by the ECJ's consistent refusal to recognize the need to raise revenue or to prevent tax base erosion as proper justifications for tax discrimination. See, e.g., Case C-422/01, *Försäkringsaktiebolaget Skandia (Publ.) v. Riksskatteverket*, 2003 E.C.R. I-6817, ¶ 53 ("[T]he need to prevent the reduction of tax revenue is not . . . a matter of overriding general interest . . . which would justify a restriction . . ."); *De Groot*, 2002 E.C.R. I-11819, ¶ 103 ("[A] loss of tax revenue can never be relied upon to justify a restriction on the exercise of a fundamental freedom." (citation omitted)).

<sup>92</sup> Mason, *supra* note 14, at 95–103 (arguing that national tax systems give voice to the particular cultural and political values of the citizens of each member state and provide a competitive regulatory market through which the best tax system has a chance to emerge).

<sup>93</sup> See, e.g., Michael J. Graetz & Alvin C. Warren, Jr., *Dividend Taxation in Europe: When the ECJ Makes Tax Policy*, 44 COMMON MKT. L. REV. 1577, 1602–03 (2007) [hereinafter Graetz & Warren, *Dividend Taxation in Europe*]; Graetz & Warren, *supra* note 14, at 1229–32.

conomic activity and investment, and reduce the risk of unrelieved double taxation. In addition, greater tax harmonization could counteract what some have characterized as a "race to the bottom" in which member states compete for investment by lowering their taxes.<sup>94</sup> Such competition could ultimately result in reduced social spending, as states cut benefits to keep pace with lesser tax revenues.<sup>95</sup>

Despite these potential benefits, greater tax harmonization in Europe is not necessarily desirable.<sup>96</sup> State tax autonomy allows states to respond quickly and flexibly to voter preferences, and the presence of competing tax jurisdictions imposes budgetary discipline on each state.<sup>97</sup> Moreover, further judicial encroachments on member state tax sovereignty could provoke backlash among the member states. If the states perceive the Court to exceed its mandate to review national tax laws for discrimination, they could narrow its jurisdiction. The member states have already considered revoking the Court's jurisdiction to review national direct tax cases.<sup>98</sup> Although this radical idea may have been motivated primarily by the desire to shield even discriminatory tax legislation from judicial review, the Court's invalidation of merely disparate tax legislation may ultimately undermine its position as the primary force for tax integration in the European Union.

Disparities, and the market distortions they create, can thus be seen as the price paid for retained member state tax sovereignty. And to avoid infringing member state tax sovereignty, the ECJ needs a reliable way to determine when cross-border tax disadvantages result from disparities.

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<sup>94</sup> See *Communication from the Commission to the Council and the European Parliament: A Package to Combat Harmful Tax Competition in the European Union*, at 3-4, COM (1997) 564 final (May 11, 1997) (discussing tax competition among the EU member states).

<sup>95</sup> See *id.* But see Wallace E. Oates, *Fiscal Competition and the European Union: Contrasting Perspectives*, 31 REGIONAL SCI. & URB. ECON. 133, 137 (2001) (characterizing the studies on inter-jurisdictional tax competition as finding that such competition results in suboptimal equilibria, rather than a "race to the bottom" or a "downward spiral in public sector activities").

<sup>96</sup> See Mason, *supra* note 14, at 100 (describing tax competition as an important component of Ireland's recent economic growth). See generally Clayton P. Gillette, *Business Incentives, Interstate Competition, and the Commerce Clause*, 82 MINN. L. REV. 447 (1997) (arguing more generally that regulatory competition between the states may be constructive).

<sup>97</sup> See, e.g., Oates, *supra* note 95, at 135-36, 143.

<sup>98</sup> See Melchior Wathelet, *Direct Taxation and EU Law: Integration or Disintegration?*, 13 EC TAX REV. 2, 4 (2004) (criticizing such suggestions made at the Intergovernmental Conference for the European Constitution).

## 2. When Lower Taxes Discriminate

Although the ECJ and commentators usually conceive of disparities as creating net cross-border disadvantages, as the tax rate and alimony examples show, differences between the tax systems of the member states may also result in net cross-border advantages. A net cross-border tax advantage does not by itself create a discrimination problem, but favorable tax treatment by one state could obscure discrimination by another. This is because a tax benefit available in one member state may compensate for tax discrimination imposed by the other taxing state, such that the overall tax paid is the same (or lower) than the tax that would be collected in a purely domestic situation. Failure by the Court to find violations in such cases undermines tax competition. It also tends to shift tax revenue from EC law-compliant states to discriminating states because the state offering the compensating tax advantage forgoes revenue to maintain a neutral (or advantageous) tax situation for the cross-border taxpayer.

An example will illustrate the point. A source state may grant tax credits on outbound income, such that, even after the residence state imposes discriminatory taxes, the taxpayer suffers no net tax disadvantage, or even comes out ahead as compared with a purely domestic transaction. Arguably, this occurred in the controversial case *Kerckhaert & Morres v. Belgium*, decided by the ECJ in 2006.<sup>99</sup> That case involved dividends paid by a company resident in France to individuals resident in Belgium.<sup>100</sup> In order to eliminate economic double taxation of corporate profits,<sup>101</sup> France operated a shareholder imputation system under which shareholders received credit for the taxes paid by the corporation.<sup>102</sup> These credits either reduced the French tax due from the

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<sup>99</sup> Case C-513/04, 2006 E.C.R. I-10967.

<sup>100</sup> See *id.* ¶¶ 1–12.

<sup>101</sup> Economic double taxation occurs when the same item of income is taxed to each of two different taxpayers. For example, corporate profits are taxed first to the company when earned, and again to the shareholder when distributed as dividends. Countries seeking to relieve economic double taxation of corporate profits employ a variety of relief mechanisms. See generally DEP'T OF THE TREASURY, INTEGRATION OF THE INDIVIDUAL AND CORPORATE TAX SYSTEMS: TAXING BUSINESS INCOME ONCE (1992); ALVIN C. WARREN, JR., INTEGRATION OF THE INDIVIDUAL AND CORPORATE INCOME TAXES: REPORTER'S STUDY OF CORPORATE TAX INTEGRATION (1993) (both studies evaluated reasons for integration and methods to achieve it). Until a recent series of judgments by the ECJ made it untenable, many of the EU member states relieved economic double taxation via shareholder imputation. See Graetz & Warren, *Dividend Taxation in Europe*, *supra* note 93, at 1591; Walter Hellerstein et al., *Constitutional Constraints on Dividend Taxation*, 61 TAX L. REV. (forthcoming 2008) (manuscript at 38).

<sup>102</sup> *Kerckhaert & Morres*, 2006 E.C.R. I-10967, ¶¶ 2–8.

shareholder on the corporation's dividends or were refundable.<sup>103</sup> Under the French system, both foreign and domestic shareholders were entitled to imputation credits.<sup>104</sup>

When a French company paid dividends to Kerckhaert and Morres in Belgium, Belgium taxed them at the rate that applied to domestic dividends, without crediting the taxes already assessed against the dividends by France.<sup>105</sup> Kerckhaert and Morres argued that Belgium's failure to credit the French tax was discriminatory because it meant that foreign dividends were subject to double taxation, while domestic dividends were not.<sup>106</sup> Due to the French imputation credit, however, Kerckhaert and Morres actually got to keep a larger proportion of the pre-tax profit on their French dividends than they would have kept on domestic dividends.<sup>107</sup> The Advocate General in the case concluded that in the absence of a net cross-border tax disadvantage compared to an equivalent domestic investment, there could be no discrimination.<sup>108</sup> Although the Court did not expressly rely on the Advocate General's reasoning to decide the case, the absence of a net tax disadvantage in *Kerckhaert & Morres* made it difficult to perceive that by fail-

<sup>103</sup> *Id.*

<sup>104</sup> *Id.*

<sup>105</sup> *Id.* ¶¶ 9-12.

<sup>106</sup> *Id.* ¶ 13.

<sup>107</sup> *Kerckhaert & Morres*, 2006 E.C.R. I-10967, ¶¶ 26-27 (opinion of Advocate General Geelhoed). Advocate General Geelhoed compared the taxation of a \$1,000 French dividend entitled to French imputation credits with a \$1,000 Belgian dividend as follows:

	French Dividend	Belgian Dividend
a. Dividend	1000	1000
b. French imputation credit (50%)	<u>500</u>	<u>n/a</u>
c. Gross Distribution	1500	1000
d. Foreign withholding tax (15%)	<u>(225)</u>	<u>n/a</u>
e. Net distribution (subject to shareholder tax in Belgium)	1275	1000
f. Belgian shareholder tax (25%)	(319)	(250)
g. Belgian credit for French withholding tax	<u>0</u>	<u>n/a</u>
h. Net after-tax distribution	956	750

*Id.* ¶ 25.

Belgium's failure to credit French withholding taxes (line g) raised concerns that it discriminated against foreign dividends, but the Advocate General concluded that since Kerckhaert and Morres retained more after-tax income from their \$1,000 French dividend than they would have retained on a \$1,000 Belgian dividend (line h), they could not have suffered discrimination. *See id.* ¶¶ 25-27.

<sup>108</sup> *Id.* ¶ 27 ("[T]he actual (favourable) effect of the legislative framework for Mr. and Mrs. Kerckhaert-Morres is in my view decisive on the facts of the present case . . .").

ing to credit foreign dividend taxation, but nevertheless assessing the full measure of domestic tax against inbound dividends, Belgium may have violated the EC Treaty by systematically subjecting dividends from foreign companies to greater overall tax than domestic dividends.<sup>109</sup>

If the purpose of the tax nondiscrimination principle is to promote intra-Community investment by removing obstacles to cross-border investments, then, to the extent that a taxpayer will not *actually* suffer a net disadvantage because of discriminatory member state taxation, one could argue that there is no reason to prohibit it.<sup>110</sup> One might thus argue that compensatory taxation in the other member state ought to be relevant to the determination of whether a particular member state violated the EC Treaty. But requiring a net cross-border tax disadvantage would unnecessarily narrow the concept of tax discrimination. When one state compensates for the tax discrimination of another, the compensating state bears the economic burden of the discriminatory tax. Tax advantages granted by source states to foreigners,

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<sup>109</sup> The argument that Belgium discriminated was based on its failure to credit foreign withholding taxes. *Id.* ¶ 14. If, rather than coming from France, the dividend had been sourced in another EU member state that did not grant shareholder imputation credits to foreign shareholders, a \$1,000 gross dividend would have been taxable as follows:

	French Dividend	Belgian Dividend	Other Member State Dividend
a. Dividend	1000	1000	1000
b. Imputation credit (50% in France)	<u>500</u>	<u>n/a</u>	<u>0</u>
c. Gross distribution	1500	1000	1000
d. Foreign withholding tax (15%)	<u>(225)</u>	<u>n/a</u>	<u>(150)</u>
e. Net distribution (subject to shareholder tax in Belgium)	1275	1000	850
f. Belgian shareholder tax (25%)	(319)	(250)	(212)
g. Belgian credit for foreign withholding tax	<u>0</u>	<u>n/a</u>	<u>0</u>
h. Net after-tax distribution	956	750	638

Thus, in the absence of source-state imputation credits, it becomes apparent that dividends sourced in other member states were subject to greater taxation than Belgian dividends (line h). For the argument that French shareholder imputation credits masked tax discrimination by Belgium in *Kerckhaert & Morres* by putting Belgian shareholders of French companies in a better after-tax position than Belgian shareholders of Belgian companies, see Georg W. Kofler & Ruth Mason, *Double Taxation: A European "Switch in Time?"*, 14 COLUM. J. EUR. L. 63, 79–81 (2007).

<sup>110</sup> This was the view of ECJ Advocate General Geelhoed. See *Kerckhaert & Morres*, 2006 E.C.R. I-10967, ¶¶ 26–27 (opinion of Advocate General Geelhoed). Advocate General Peter Wattel of the Dutch Supreme Court appears to hold similar views. See Weber, *supra* note 14, at 603–07 (criticizing Wattel's view that discrimination by the source state does not violate EC law as long as the taxpayer pays no more tax overall after taking into consideration the residence state's credit system).

including the French shareholder imputation credit, are not free. To offer such tax advantages, the source state forgoes tax revenue or makes direct payments to the taxpayer. Allowing discriminatory taxes in the residence state to neutralize tax advantages offered by the source state would undermine the source state's ability to compete for foreign investment.<sup>111</sup>

The ECJ has acknowledged that one of the consequences of creating the common market was tax competition among the member states, and, more generally, that creating a robust regulatory marketplace was an explicit aim of the common market.<sup>112</sup> In 1999, in *Eurowings Luftverkehrs AG v. Finanzamt Dortmund-Unna*, the ECJ held that Germany could not assess higher taxes on German businesses leasing from Irish companies in order to compensate for the fact that Irish companies were subject to lower taxation at home.<sup>113</sup> The ECJ noted that, "[a]s the Commission rightly observed, such compensatory tax arrangements prejudice the very foundations of the single market."<sup>114</sup> Thus, contrary to the arguments of some commentators, permitting tax discrimination when it does not result in a net tax disadvantage for the taxpayer may affect the common market by undermining tax competition.

Moreover, when one state compensates for the tax discrimination of another, the result is to shift tax revenue from an EC law-compliant state to a discriminating state. The potential for revenue shifting can be demonstrated with a simple example. The United Kingdom taxes its residents' worldwide income, but, against the British tax due on foreign source income, the United Kingdom allows its residents credits for taxes paid to the source state.<sup>115</sup> Suppose that the Netherlands assessed a discriminatory \$10 tax against Smith, a U.K. resident, whereas the

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<sup>111</sup> The EC prohibition on state aids limits the member states' ability to grant tax incentives to encourage inbound investment. See EC Treaty art. 87 ("[A]id granted by a Member State . . . in any form whatsoever which distorts or threatens to distort competition . . . shall, in so far as it affects trade between Member States, be incompatible with the common market . . ."). Certain enticements, however, such as uniformly low rate rates, are permissible.

<sup>112</sup> See, e.g., Case C-167/01, *Kamer van Koophandel en Fabrieken voor Amsterdam v. Inspire Art Ltd.*, 2003 E.C.R. I-10155, ¶¶ 137-38, 143; Case C-212/97, *Centros Ltd. v. Erhvervs- og Selskabsstyrelsen*, 1999 E.C.R. I-1459, ¶ 26-27.

<sup>113</sup> See Case C-294/97, 1999 E.C.R. I-7447, ¶ 29. The Court rejected as a justification for higher taxation Germany's argument that the "lessor established in another Member State might be able to charge the lessee a lower rental because he is not liable to trade tax." *Id.*

<sup>114</sup> *Id.* ¶ 45.

<sup>115</sup> See Avery Jones, *supra* note 14, at 3 (describing how the resident state's foreign tax regime could compensate for discrimination by the source state).

nondiscriminatory tax would have been \$6. Suppose further that the U.K. tax on the same income was \$11. If the United Kingdom fully credits the discriminatory Dutch tax, Smith will suffer no overall tax disadvantage. She will pay \$11 in taxes overall, consisting of \$10 paid to the Netherlands and \$1 paid to the United Kingdom (the U.K. tax due is \$11 less the \$10 credit for Dutch taxes paid). Although Smith's overall tax liability would be unaffected by the Netherlands' discrimination, the discrimination shifts revenue from the United Kingdom to the Netherlands. In this example, the United Kingdom collected only \$1 of tax, instead of the \$5 it would have collected had the Netherlands not discriminated. Thus, discrimination by the source state may make maintenance of capital export neutrality more expensive for the residence state.

In addition to undermining tax competition and shifting tax revenue from EC-law compliant states to discriminatory states, when the ECJ fails to recognize discriminatory taxes because they are obscured by advantages offered by other member states, the ECJ narrows the rights of EU nationals and allows the states to maintain distortive taxes that reduce social welfare.<sup>116</sup> The EC Treaty's prohibition of nationality discrimination will only reinforce economic and political union to the extent that the Court recognizes and censures discrimination. Thus, it is crucial that the ECJ adopt a method of analyzing tax cases that will bring even obscure tax discrimination to light.

#### D. *A Methodology, Not a Standard of Review*

Advocate General Geelhoed observed that the key feature distinguishing disparity from discrimination is that discrimination "occurs as the result of the rules of just one tax jurisdiction," whereas disparity results from the interaction of the laws of two states.<sup>117</sup> Although this observation is helpful, the exercise of tax jurisdiction by at least two states in almost all cross-border tax cases makes it difficult for the Court to determine when tax disadvantages arise from just one state's law and

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<sup>116</sup> ALEC STONE SWEET, *GOVERNING WITH JUDGES: CONSTITUTIONAL POLITICS IN EUROPE* 96 (2000). Stone Sweet notes that although the ECJ has elaborated "a charter of rights for the Community," the original purpose of the fundamental freedoms "was not so much to create rights claims for individuals, as to remove potential distortions within an emerging common market." *Id.* at 170-71.

<sup>117</sup> See *Test Claimants v. Comm'rs of Inland Revenue*, 2006 E.C.R. I-11673, ¶ 46 (opinion of Advocate General Geelhoed); see also Weber, *supra* note 14, at 588.



when they arise from the interaction of two states' laws.<sup>118</sup> If the ECJ were simply to invalidate all cross-border tax disadvantages, without regard to whether they stemmed from discrimination or disparity, the Court would invade the reserved tax competence of the member states to independently determine their tax laws. To avoid this, the Court needs a reliable method to distinguish between cross-border tax disadvantages caused by discrimination and those caused by disparities.

Before discussing the methods currently in use by the Court to analyze tax discrimination cases involving overlapping taxation and before introducing a proposal for a new approach, it is worth noting that this Article proposes a method of analysis, not a standard of review.<sup>119</sup> The Court could employ the internal consistency test to help it understand the tax situation in the defendant member state, but the method does not, by itself, provide criteria for deciding cases. After applying the harmony constraint, the Court would still have to apply its pre-existing tax discrimination standard to any remaining tax disadvantages to determine whether they violate EC law. The problem identified and addressed here is that *no matter what standard the Court uses* to evaluate member state tax laws, overlapping taxation as a structural feature of international taxation tends to obscure the presence of discrimination in some cases and to suggest its presence where there is none in other cases.

Thus, arguments that the Court should strike a different balance in reviewing national tax laws in order to afford member states greater tax autonomy, or in the alternative, to offer greater protection to EU taxpayers, although important, are not relevant here.<sup>120</sup> Instead, this Article takes the Court's discrimination standard as a given and offers a method of analysis that should allow the Court to more easily and accurately apply that standard to tax cases.<sup>121</sup>

## II. CURRENT APPROACHES TO ANALYZING TAX DISCRIMINATION

Without explicitly conceiving of overlapping taxation as creating both positive and negative disparities that obscure discrimination in the ways described above, both the ECJ and commentators have been aware that taxation by more than one state poses difficulties in evaluat-

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<sup>118</sup> It is also possible for both countries to discriminate in the taxation of cross-border income.

<sup>119</sup> For further discussion, see *infra* notes 199–210 and accompanying text.

<sup>120</sup> For articles concerning the Court's discrimination standards, see references in note 14, *supra*.

<sup>121</sup> See *infra* notes 162–198 and accompanying text.

ing tax cases.<sup>122</sup> This difficulty is most noticeable when the Court tries to limit the scope of its inquiry in a tax case. The Court has struggled with the question of whether the tax rules of the residence state are relevant to the determination of whether the source state discriminated and vice versa.<sup>123</sup> For example, if Smith, the U.K. tax resident working in the Netherlands, sues the Netherlands for violating her fundamental freedoms by denying her a tax benefit available to Dutch residents, to what extent should the ECJ take into consideration tax benefits available under British law that reduce or eliminate the harm of the Dutch tax rule? Should positive disparities be considered to mitigate the harm of tax discrimination? If Smith pays higher taxes on her cross-border income than she would on purely domestic income, how can the Court determine whether the disadvantage constitutes discrimination (caused by British law alone or Dutch law alone) or a negative disparity (caused by the interaction of nondiscriminatory British and Dutch laws)?

The ECJ has taken two different and incompatible approaches to overlapping tax situations, which commentators have named the "per-country approach" and the "overall approach."<sup>124</sup> Under the per-country approach, the Court considers the laws of the defendant state in isolation.<sup>125</sup> In contrast, under the overall approach, the Court considers both the laws of the defendant member state and the other taxing state, giving it an "overall" view of the tax situation, including both source and residence taxation.<sup>126</sup> This Part describes the two methodologies and explains why each inadequately addresses problems created by overlapping taxation.

### A. The Methods

As a defense against accusations of tax discrimination, member states often argue that disadvantages imposed on nonresidents under

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<sup>122</sup> See *infra* notes 123–161 and accompanying text.

<sup>123</sup> See Case C-374/04, *Test Claimants v. Comm'rs of Inland Revenue*, 2006 E.C.R. I-11673, ¶ 95 (opinion of Advocate General Geelhoed); Weber, *supra* note 14, at 599.

<sup>124</sup> See, e.g., Weber, *supra* note 14, at 599; see also *Test Claimants v. Comm'rs of Inland Revenue*, 2006 E.C.R. I-11673, ¶ 95 (opinion of Advocate General Geelhoed). Note that "per-country" and "overall" are simply names given by commentators and advocates general to these perspectives, though the judgments of the ECJ do not contain explicit references to these approaches, and indeed, the Court's decisions do not acknowledge that the Court has taken different approaches in different cases. Compare Case C-294/97, *Eurowings Luftverkehrs AG v. Finanzamt Dortmund-Unna*, 1999 E.C.R. I-7447, ¶¶ 43–44, with Case C-319/02, *In re Manninen*, 2004 E.C.R. I-7477, ¶ 54.

<sup>125</sup> See, e.g., *Eurowings*, 1999 E.C.R. I-7447, ¶¶ 43–44.

<sup>126</sup> See, e.g., *Manninen*, 2004 E.C.R. I-7477, ¶ 54.

their tax laws are compensated by advantages available in the taxpayer's home state. For example, in *Eurowings Luftverkehrs AG v. Finanzamt Dortmund-Unna*, decided by the ECJ in 1999, Germany imposed higher trade taxes on German companies that leased equipment from foreign companies than it imposed on German companies that leased equipment from other German companies.<sup>127</sup> The German referring court asked the ECJ whether the absence of trade taxes in Ireland and low Irish corporate tax rates were relevant to determining whether the German rule violated an Irish lessor's freedom to provide services in Germany.<sup>128</sup> In the view of the German government, because the Irish lessor was not subject to trade tax in Germany or in Ireland, it was not similarly situated to a German lessor, and it therefore did not have to be treated similarly to a German lessor.<sup>129</sup>

The ECJ rejected Germany's argument and held that:

Any tax advantage resulting for providers of services from the low taxation to which they are subject in the member state in which they are established cannot be used by another member state to justify less favourable treatment in tax matters given to recipients of services established in the latter State.<sup>130</sup>

Thus, a member state may not justify tax discrimination on the grounds that the taxpayer is subject to lower taxation elsewhere in the Community.<sup>131</sup> This result is consonant with the idea that a purpose of the EU common market is to facilitate EU nationals' access to tax and regulatory advantages available in other member states.<sup>132</sup>

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<sup>127</sup> *Eurowings*, 1999 E.C.R. I-7447, ¶ 19. The method of discrimination in *Eurowings* was indirect: rather than explicitly assessing higher trade taxes on leases from foreign companies, Germany granted a partial exemption from trade tax to companies renting equipment from other companies also liable for trade tax. See *id.* ¶ 18. Since foreign companies tended not to be liable for trade tax in Germany, the impact of the facially neutral law was disparate. See *id.* ¶ 19.

<sup>128</sup> *Id.* ¶ 21.

<sup>129</sup> *Id.* ¶ 28. The Irish lessor paid no trade tax in Ireland and enjoyed "Shannon privileges" in the form of a 10% corporate tax rate. *Id.* ¶ 21.

<sup>130</sup> *Id.* ¶¶ 43-44 (citing Case 270/83, *Comm'n v. France*, 1986 E.C.R. 273 & Case C-107/94, *Asscher v. Staatssecretaris van Financiën*, 1996 E.C.R. I-3089, for the proposition that that discrimination by the host state could not be compensated by unrelated tax advantages granted to the nonresident by the host state).

<sup>131</sup> See *id.* The U.S. Supreme Court takes a similar approach when evaluating state tax discrimination. See *Am. Trucking Ass'n, Inc. v. Scheiner*, 483 U.S. 266, 288 (1987). The Supreme Court stated that "the Commerce Clause does not permit compensatory measures for the disparities that result from each State's choice of tax levels." *Id.*

<sup>132</sup> See Case C-212/97, *Centros Ltd. v. Erhvervs- og Selskabsstyrelsen*, 1999 E.C.R. I-1459, ¶ 27. The Court in *Centros* held that, except in cases of fraud, Denmark could not

Although in *Eurowings* the Court adopted a per-country approach under which it declared that the tax situation in the residence state had no bearing on the question of whether the accused source state discriminated, the Court has also taken the opposite approach in some cases. Under the overall approach, the Court considers the overall tax situation in both the defendant state and other taxing state to determine whether the defendant state violated EC law.<sup>133</sup>

For example, in *In re Manninen*, decided by the ECJ in 2004, Finland granted resident shareholders of domestic companies imputation credits to relieve the burden of double taxation of corporate profits, but it denied such credits to resident shareholders of foreign companies.<sup>134</sup> Manninen was a Finnish shareholder taxable in Finland on dividends he received from a Swedish company, but he was denied Finnish imputation credits.<sup>135</sup> He argued that Finland discriminated against him when it denied him imputation credits on dividends from a company established in another member state.<sup>136</sup> Finland defended its rule by arguing that domestic corporate profit distributions were dissimilar to inbound corporate profit distributions.<sup>137</sup> The dissimilarity arose because Finland taxed inbound distributions only once, in the hands of the shareholder, but it taxed domestic distributions twice—once in the hands of the corporation when it earned the profits, and again in the hands of the shareholder upon distribution.<sup>138</sup> Because Finland subjected only domestic distributions to economic double tax-

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refuse to recognize the Danish secondary establishment of a company primarily established in the United Kingdom, even if the U.K. establishment had no activities and appeared to be established in the United Kingdom for the purpose of avoiding Danish corporate capitalization rules, stating:

[T]he fact that a national of a Member State who wishes to set up a company chooses to form it in the Member State whose rules of company law seem to him the least restrictive and to set up branches in other member states cannot, in itself, constitute an abuse of the right of establishment.

*Id.*; see also Case C-167/01, *Kamer van Koophandel en Fabrieken voor Amsterdam v. Inspire Art Ltd.*, 2003 E.C.R. I-10155, ¶ 143 (holding that the ability to form a company in one member state with the specific intent to establish a branch in a second state, while taking advantage of favorable law in the first state, is an essential part of the freedom of establishment).

<sup>133</sup> The Court has taken this approach in many of the recent controversial cross-border dividend cases. See, e.g., *Manninen*, 2004 E.C.R. I-7477, ¶ 54. For critical discussion of these cases, see generally Graetz & Warren, *Dividend Taxation in Europe*, *supra* note 93.

<sup>134</sup> For discussion of imputation credits, see *supra* notes 99–116 and accompanying text.

<sup>135</sup> *Manninen*, 2004 E.C.R. I-7477, ¶¶ 12–13.

<sup>136</sup> *Id.* ¶ 14.

<sup>137</sup> *Id.* ¶¶ 26–27.

<sup>138</sup> *Id.* ¶¶ 27, 30.

tion, and the imputation credit was designed to provide relief from economic double taxation, Finland argued that it was appropriate to limit imputation credits to domestic dividends.<sup>139</sup>

Nevertheless, taking the overall situation into account, the Court held that domestic and inbound dividends were similar because both actually were subject to economic double taxation.<sup>140</sup> In the case of domestic dividends, Finland collected both the corporate- and shareholder-level taxes, but in the case of dividends inbound from Sweden, although Finland only collected the shareholder-level tax, the corporate-level tax had been collected from the Swedish corporation by *Sweden*.<sup>141</sup> Thus, taking into account the taxation by both the source state (Sweden) and the residence state (Finland), domestic and inbound dividends were both subject to double taxation, and Finland could not tax them differently.<sup>142</sup>

The ECJ came to a similar conclusion in 2005 with respect to corporate tax losses in *Marks & Spencer plc v. Halsey*.<sup>143</sup> In that case, the ECJ applied the overall approach to conclude that where the state of establishment of a subsidiary could not grant the subsidiary the tax benefit of its losses, the state of establishment of its parent company must allow those losses to offset the income of the parent company or other companies in its corporate group.<sup>144</sup> In both *Manninen* and *Marks & Spencer*, the tax obligations of one state were thus expressly conditioned on the tax treatment by another state.<sup>145</sup>

### B. Criticism

One might argue that the Court should choose a method and then stick with it. If, as the analysis of *Eurowings* and *Manninen* suggests, the choice of method affects the outcome of the case, then failure to commit to a particular methodology introduces excessive legal uncertainty into an area in which certainty is particularly important. In order for the member states to make reliable budgetary predictions, they need to be able to assess the risk that their tax laws will be

<sup>139</sup> *Id.* ¶ 30.

<sup>140</sup> *Manninen*, 2004 E.C.R. I-7477, ¶¶ 54–55.

<sup>141</sup> *Id.* ¶¶ 12–13.

<sup>142</sup> *Id.* ¶¶ 54–55.

<sup>143</sup> See C-446/03, *Marks & Spencer plc v. Halsey*, 2005 E.C.R. I-10837, ¶ 59.

<sup>144</sup> *Id.* ¶ 55. The parent company's state must allow the losses of a foreign subsidiary only if there is "no possibility" that the foreign subsidiary will be able to take the losses in its own state of establishment now or in the future. *Id.*

<sup>145</sup> *Id.* ¶ 59; *Manninen*, 2004 E.C.R. I-7477, ¶ 54.

held to violate EC law. Likewise, EU taxpayers contemplating cross-border investments need to be able to estimate their tax exposure. If the Court continues to apply inconsistent methods, even a member state making good faith efforts to conform its tax system to EC law will have trouble determining which laws require reform, and EU taxpayers will not be able to reliably predict their entitlements under EC law.

Perhaps shifting between the per-country approach and the overall approach would be acceptable if each approach were more effective for certain kinds of cases.<sup>146</sup> But the Court has offered no explanation for why it vacillates between the approaches, and, indeed, it has never explicitly acknowledged that it has adopted different approaches in different cases.<sup>147</sup> Making matters worse, the Court does not apply the overall approach in the same way every time. The Court sometimes analyzes the actual law of the other member states involved, but at other times it speculates about what the other state's law might be and decides the case based on those assumptions.<sup>148</sup>

In addition to the Court's inconsistent application of the methods, aspects of each approach may lead to judicial error. As a proponent of the overall approach, Advocate General Geelhoed warned that the per-country approach is too narrow and could lead the Court to faulty conclusions:

Examination of the situation of an individual economic operator in the framework of just one of these States—without taking into account the [EC Treaty] obligations of the other State—may give an unbalanced and misleading impression,

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<sup>146</sup> The Court seems to be more inclined to adopt the overall approach in cases involving tax benefits. See, e.g., *Marks & Spencer*, 2005 E.C.R. I-10837, ¶ 59; *Case C-279/93, Finanzamt Köln-Alstadt v. Schumacker*, 1995 E.C.R. I-225, ¶¶ 36, 41. For example, the ECJ seems to want to ensure that certain tax benefits, such as personal exemptions and loss offsets, are allowed *at least once, but no more than once*, within the EU. See, e.g., *Marks & Spencer*, 2005 E.C.R. I-10837, ¶ 59. To ensure this kind of treatment, the Court needs to look at the tax treatment in both states. See, e.g., *id.* (holding that if the state of a subsidiary cannot grant tax relief for the subsidiary's losses, then the parent company's state must allow the loss); *Schumacker*, 1995 E.C.R. I-225, ¶¶ 36, 41 (holding that if the residence state cannot grant personal tax benefits, the source state must).

<sup>147</sup> Compare *Eurowings*, 1999 E.C.R. I-7447, ¶¶ 43–44, with *Manninen*, 2004 E.C.R. I-7477, ¶ 54.

<sup>148</sup> Compare *Case C-204/90, Bachmann v. Belgium*, 1992 E.C.R. I-249, ¶¶ 11, 35 (holding that the host state discriminated on the *assumption* that the complaining taxpayer's home state would tax the relevant income, without reference to actual home state law), with *Manninen*, 2004 E.C.R. I-7477, ¶ 54 (holding that the residence state discriminated in light of the *actual* assessment of corporate tax by the source state).

and may fail to capture the economic reality in which that operator is acting.<sup>149</sup>

In Advocate General Geelhoed's view, the obligations of the source and residence states must "be seen as a whole, or as achieving a type of equilibrium."<sup>150</sup> By adopting a per-country approach, the Court may ignore relevant tax treatment in the other member state that bears on whether the defendant state discriminated. For example, Finland's argument in *Manninen* that only domestic, but not inbound, dividends were subject to economic double taxation may have seemed persuasive until the Court considered that the corporate profits comprising Manninen's inbound dividend had already been taxed by Sweden to the distributing company.<sup>151</sup>

In addition to leading the Court to a false conclusion that a member state did not discriminate, the per-country approach could also lead the Court to erroneously conclude that the member state discriminated. For example, by exclusively examining the tax of the defendant state, the Court could overlook the fact that the defendant member state arranged for another state to cure the discrimination. Such bargains might be struck in tax treaties. In deference to member state tax sovereignty, the Court has held that a member state may shift its EC tax obligations under such binding legal instruments.<sup>152</sup>

Although better than the per-country approach, the overall approach also suffers certain drawbacks: it allows the Court to get a broader perspective on the tax situation, but it increases legal uncertainty.<sup>153</sup> First, it is more difficult to apply because the Court must con-

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<sup>149</sup> *Test Claimants v. Comm'rs of Inland Revenue*, 2006 E.C.R. I-11673, ¶ 72 (opinion of Advocate General Geelhoed).

<sup>150</sup> *Id.*

<sup>151</sup> See *Manninen*, 2004 E.C.R. I-7477, ¶ 54.

<sup>152</sup> See Case C-379/05, *Amurta v. Inspecteur van de Belastingdienst*, 2007 E.C.R. I-9569, ¶ 84 (holding that a source state could shift its obligation to relieve economic double taxation on cross-border dividends to the shareholder's residence state through a tax treaty); Case C-385/00, *De Groot v. Staatssecretaris van Financiën*, 2002 E.C.R. I-11819, ¶¶ 99-101 (declaring that where the residence member state has the primary obligation to confer a tax benefit, that obligation may be shifted to the source state under a tax treaty consistently with EC law).

<sup>153</sup> Expressly for this reason, the European Free Trade Association ("EFTA") Court recently refused to adopt the overall approach when analyzing a tax case under the fundamental freedoms of the European Economic Area Agreement. Case E-1/04, *Fokus Bank ASA v. Norway*, [2005] 1 C.M.L.R. 10, ¶ 37 (Eur. Free Trade Area Ct. 2004). According to the EFTA Court, "[T]he principle of legal certainty would require that the granting, or not, of an imputation tax credit to a nonresident shareholder, may not depend on whether a tax credit is granted in his or her state of residence in respect of dividend payments." *Id.*; see also Graetz & Warren, *Dividend Taxation in Europe*, *supra* note 93, at 1617.

sider not only the law of the defendant member state, but also the law of the other member state, even though that state might not participate in the proceedings.<sup>154</sup> Although all member states have the option to enter comments on preliminary rulings, they are not compelled to do so.<sup>155</sup> Thus, the Court may have to rely on the Commission, the defendant member state, and the taxpayer to accurately describe the tax consequences in the other member state. Any resulting judgment by the Court would only be reliable to the extent that the parties accurately described foreign law.

Moreover, because the ability of each state to enact tax laws independently of the laws of the other states is an important aspect of retained tax competence, each member state's tax law should stand or fall on its own merits. The determination of whether a member state discriminates in violation of the EC Treaty should not depend on the dynamic laws of each of the twenty-six other member states.<sup>156</sup> But under the overall approach, the outcome of cases depends closely on the tax situation in the other member state. If the Court had adopted an overall approach in *Eurowings*, under which it would have considered the low taxation in Ireland relevant to the discrimination question, it might have concluded that because a German-Irish lease would bear less overall tax than a German-German lease, there was no cross-border disadvantage, and therefore, perhaps, no cross-border discrimination, even though Germany subjected German-foreign leases to higher taxes than German-German leases. But suppose a subsequent challenge involved a lessor from a member state with higher taxes than Germany's. Would the Court now reach a different result, even though it would be analyzing the same German lease rule? Likewise, suppose that in *Maninen*, the company's member state did not have a corporate tax. Would Finland's rule be constitutional with respect to dividends inbound from that member state, but not Sweden? Could the overall approach result in a situation where the same defendant state's law is dis-

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<sup>154</sup> Professor Dennis Weber has called the overall approach "a particularly tedious affair since, as a result of the very sovereignty member states have in taxation, the legislation of the various member states is difficult to compare and the various types of income are equally difficult to compare." Weber, *supra* note 14, at 603.

<sup>155</sup> See MASON, *supra* note 4, at 18-19.

<sup>156</sup> When analyzing state tax discrimination under the Commerce Clause, the U.S. Supreme Court declined to require a taxpayer to show actual discriminatory impact by pointing to a duplicative tax in another U.S. state (in essence, the ECJ's "overall approach") because then the constitutionality of the accused state's tax law "would depend on the shifting complexities of the tax codes of 49 other States." *ARMCO Inc. v. Hardesty*, 467 U.S. 638, 644 (1984).



criminatorily with respect to investment in some member states, but not others?<sup>157</sup>

If so, the order of decisions by the ECJ might take on paramount importance. Under the *acte clair* doctrine, a national court of a member state is not obliged to refer questions to the ECJ whose answers are clear.<sup>158</sup> If the overall approach means that the same tax law could be discriminatory when applied to cross-border activities in some member states, but not others, national courts would face uncertainty regarding whether similar subsequent cases must be referred to the ECJ. For example, after *Kerckhaert & Morres*, will a Belgian national court find it necessary to make another reference to the ECJ when faced with a case involving inbound dividends not carrying source state imputation credits that compensate for Belgian shareholder taxation?<sup>159</sup> Or should Belgian courts regard the ECJ's decision as completely resolving the issue of the constitutionality of Belgian dividend taxation?

So far, it appears that national courts unsure of the scope of decisions rendered by the ECJ under the overall approach will make further preliminary ruling requests to the Court. For example, France recently amended its domestic tax code to eliminate the shareholder imputation credit, and a Belgian national court has once again referred to the ECJ a question concerning whether Belgian tax treatment of dividends inbound from France violates EC law.<sup>160</sup> The second preliminary ruling request concerns precisely the same Belgian tax laws at issue in *Kerckhaert & Morres*, and it highlights that, to the extent that the overall approach depends on the particular tax laws of the other member state, the approach fails to provide legal certainty.<sup>161</sup>

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<sup>157</sup> In recent case law, the Court appears to hold that a member state's constitutional tax obligations depend on the tax situation in the other member state. See Case C-446/04, *Test Claimants in the FII Group Litig. (Franked Investment Income)*, 2006 E.C.R. I-11753, ¶¶ 53-56; *Manninen*, 2004 E.C.R. I-7477, ¶ 54. In *Manninen* and the subsequent *Franked Investment Income* cases, the Court noted that that the shareholder's residence state could alter its imputation credit based on the amount of corporate tax to which the inbound dividend had been subject in the company's state. See *Franked Investment Income*, 2006 E.C.R. I-11753, ¶¶ 53-56; *Manninen*, 2004 E.C.R. I-7477, ¶ 54 ("[T]he calculation of [the] credit . . . must take account of the tax actually paid by the company established in that other member state . . ."). Contrast this with the view of the U.S. Supreme Court. See *Am. Trucking*, 483 U.S. at 288; see also *supra* note 131.

<sup>158</sup> Case C-283/81, *CILFIT srl v. Ministry of Health*, 1982 E.C.R. 3415, ¶ 21.

<sup>159</sup> See Case C-513/04, *Kerckhaert & Morres v. Belgium*, 2006 E.C.R. I-10967.

<sup>160</sup> Case C-128/08, *Jacques Damseaux v. État Belge* (filed Mar. 28, 2008), available at <http://curia.europa.eu/en/content/juris/index.htm>.

<sup>161</sup> *Id.*

### III. THE SOLUTION: THE INTERNAL CONSISTENCY TEST

The internal consistency test provides a solution to the seemingly intractable choice between the per-country and overall approaches. The per-country approach gives the ECJ too limited a view of the taxpayer's situation. And, by requiring the Court to consider the tax situation in the other member state, the overall approach creates uncertainty and the risk that the same member state's tax provision could comply with EC law with respect to some member states but not others. Under the internal consistency test, the Court would consider the tax law of only a single member state: the defendant. But in order to get the balanced perspective that comes from considering both source and residence rules under the overall approach, the Court would hypothetically assume that the defendant state's tax laws applied both inbound and outbound. In other words, the Court would apply the defendant state's source rules *and* the defendant state's residence rules.

Under the internal consistency test, the ECJ would adopt what I call the "harmony constraint" by assuming that all the member states apply tax law identical to the defendant member state's. Judicial precedent for the internal consistency test exists in the United States, where the U.S. Supreme Court uses it to evaluate taxes imposed by U.S. states. The U.S. Supreme Court asks whether, if all fifty states enacted the challenged tax rule, interstate commerce would bear a burden that purely domestic commerce would not also bear.<sup>162</sup> In contrast with what this Article suggests for the ECJ, the U.S. Supreme Court uses internal consistency as a standard, rather than a method.<sup>163</sup> Thus, under the

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<sup>162</sup> See, e.g., *Okla. Tax Comm'n v. Jefferson Lines, Inc.*, 514 U.S. 175, 185 (1995) (describing the internal consistency approach as applied in the United States). According to the U.S. Supreme Court,

[i]nternal consistency is preserved when the imposition of a tax identical to the one in question by every other State would add no burden to interstate commerce that intra-state commerce would not also bear. This test asks nothing about the economic reality reflected by the tax, but simply looks to the structure of the tax at issue to see whether its identical application by every State in the Union would place interstate commerce at a disadvantage compared with intrastate commerce.

*Id.* (upholding Oklahoma's sales tax on the full price of tickets for interstate bus travel because if every state applied the same rule, interstate bus travel would be taxed only by the state where the ticket was purchased). Internal consistency was first developed by the Supreme Court for evaluating apportionment claims under the Commerce and Due Process Clauses. See, e.g., *id.*; see also Hellerstein, *Internal Consistency I*, *supra* note 29, at 138; Hellerstein, *Internal Consistency II*, *supra* note 29, at 4 n.13.

<sup>163</sup> See *Jefferson Lines*, 514 U.S. at 185.

U.S. Supreme Court's jurisprudence, a state tax law that lacks internal consistency is unconstitutional.<sup>164</sup> Later, Part IV discusses the reasons why internal consistency cannot be used as a tax discrimination standard in Europe.<sup>165</sup>

### A. *How (and Why) It Works*

The internal consistency test exploits the insight that if member state tax systems were harmonized, there would be no disparities.<sup>166</sup> Thus, any cross-border tax disadvantage that remains after application of the harmony constraint cannot be due to tax disparities. By providing the Court a way to filter out cases in which cross-border tax disadvantages were caused by disparities, the internal consistency test could reduce the risk that the Court would infringe member state tax autonomy by striking down disparate cross-border tax rules that it mistakes for discriminatory tax rules. It could therefore reduce occurrences of what might be called "false positives."

Second, hypothetical harmonization also eliminates positive disparities, in which tax benefits unilaterally offered by one state compensate for the tax discrimination of another. By harmonizing away the effect of compensatory taxes, the internal consistency test could also help the ECJ avoid "false negatives," in which the Court fails to identify tax discrimination due to the absence of a net cross-border tax disadvantage. Compensatory taxes that obscure tax discrimination appear to be a rare phenomenon, so the principal virtue of the internal consistency test is that it highlights which cross-border tax disadvantages deserve close scrutiny from the Court under its discrimination standard.

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<sup>164</sup> See *id.* In *Jefferson Lines*, the Supreme Court held:

A failure of internal consistence shows as a matter of law that a State is attempting to take more than its fair share of taxes from the interstate transaction, since allowing such a tax in one State would place interstate commerce at the mercy of those remaining States that might impose an identical tax.

*Id.* (emphasis added).

<sup>165</sup> See *infra* notes 199–230 and accompanying text. Despite the intriguing resemblance between the internal consistency test and Kant's categorical imperative, the inspiration for this proposal is not Kant's ethics, but rather the U.S. Supreme Court's tax jurisprudence, including *Jefferson Lines*. See, e.g., 514 U.S. at 185. I believe that a logical examination of the internal consistency test suffices to show its merits in the tax context, without the need to delve into Kant's philosophy.

<sup>166</sup> Recall that the ECJ defines tax disparities as cross-border tax disadvantages stemming from lack of EU-wide tax harmonization. See *supra* notes 40–61 and accompanying text.

### B. *Identifying Disparate Tax Rates and Tax Bases*

Applying the internal consistency test to the hypothetical tax rate scenarios presented in Part I of this Article demonstrates its virtues. Recall that member state High would discriminate against Mary, a taxpayer resident in member state Low, if it taxed her at 60% while taxing its own residents at only 50%.<sup>167</sup> Under the harmony constraint, we would assume that all the member states would tax their own residents at 50%, while taxing nonresidents at 60%. In such a situation, EU taxpayers engaged in cross-border economic activity would always face higher tax burdens than taxpayers operating wholly domestically. Because the tax disadvantage persists despite hypothetical harmonization, it cannot be due to tax disparities, and therefore may result from discrimination.

Although probative, persistence of the disadvantage under the harmony constraint does not prove that there was discrimination.<sup>168</sup> The ECJ could find that internally inconsistent member state tax laws were justified for public policy reasons, or it could find that the cross-border and internal situations were so dissimilar that the member state was not required to treat them the same. As a result, although a failure of internal consistency tends to suggest discrimination, it is not sufficient to establish a violation of EC law. Thus, rather than constituting a *per se* violation of the EC Treaty, a failure of internal consistency should be understood to create a rebuttable presumption of discrimination.

The internal consistency test also confirms that tax rate differentials, if uniformly applied, represent disparities, not discrimination.<sup>169</sup> Again suppose that member state High's tax rate is 50% while member state Low's rate is 25%, but now assume that both states apply that rate uniformly to both residents and nonresidents. As noted in Part I, Mary would face a higher tax rate in High than she would on similar investments or activities in Low.<sup>170</sup> Thus, she would suffer a tax disadvantage on her cross-border economic activities that she would not face on purely domestic activities. If she challenged High's 50% rate, however, and the Court applied the internal consistency test, the Court would assume that every member state had the same 50% tax rate as High. Under hypothetical harmonization, Mary would be taxed at 50% in

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<sup>167</sup> See *supra* notes 80–83 and accompanying text.

<sup>168</sup> See *infra* notes 206–210 and accompanying text.

<sup>169</sup> See *supra* notes 74–116 and accompanying text.

<sup>170</sup> See *supra* notes 80–83 and accompanying text.

both Low and High, and the cross-border tax disadvantage would disappear. Disappearance of the cross-border tax disadvantage under the harmony constraint shows that the disadvantage was due to lack of harmonization between the tax laws of High and Low and therefore stemmed from a disparity, not discrimination by High. Because the ECJ has stated that disadvantages caused by disparities are not discriminatory, determining that a cross-border tax advantage was due to a disparity would dispose of the discrimination question.<sup>171</sup>

The same result would occur if either the German or the Austrian system for taxing alimony were universalized. In the example reviewed in Part I, alimony paid by an Austrian payer to a German recipient could be subject to tax in both Austria and Germany due to disparities in those states' tax systems.<sup>172</sup> The challenge for the ECJ was to recognize that this cross-border tax disadvantage stemmed from disparity, rather than discrimination.<sup>173</sup> Analysis under the harmony constraint makes this conclusion more obvious. Suppose that the alimony recipient resides in Germany and challenges German taxation of the receipt of the alimony on the grounds that Austria already included the alimony in the payer's income when earned (without allowing a deduction for the alimony payment). Under the harmony constraint, we assume all member states would adopt the German system for taxing alimony: they would allow the payer a deduction and include the alimony in the income of the recipient. Under this hypothetical assumption, Austria (applying German law) would allow the alimony payer a deduction, and Germany would include the alimony in the income of the recipient, resulting in only a single tax.<sup>174</sup> Disappearance of the tax disadvantage under the harmony constraint shows that the disadvantage derives from lack of harmonization rather than discrimination. Once the ECJ has a reliable way to determine when cross-border tax

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<sup>171</sup> See, e.g., Case C-336/96, *Gilly v. Directeur des Services Fiscaux du Bas-Rhin*, 1998 E.C.R. I-2793, ¶¶ 49, 53 (holding that a cross-border tax disadvantage due to tax rate disparities was not discrimination). There could still be a question of whether the member state violated EC law by imposing a nondiscriminatory restriction on intra-Community commerce. See *infra* notes 201-210 and accompanying text.

<sup>172</sup> See *supra* notes 84-89 and accompanying text.

<sup>173</sup> See *supra* notes 84-89 and accompanying text.

<sup>174</sup> Notice also that if the payer sued Austria, the ECJ would universalize the Austrian rule, such that Austria would include the alimony in the payer's income and disallow any deduction, while Germany (now hypothetically applying Austrian law) would exempt the alimony from the income of the recipient. Again, there would be only a single layer of tax on the cross-border alimony payment. The fact that each state's rule, if universalized, would result in no cross-border tax disadvantage shows that the tax disadvantage experienced by the complaining taxpayer results from disparity, not discrimination.

disadvantages are caused by disparities, it can give disparities deference, thereby also deferring to member states' tax autonomy.

One might object to the notion that, because they adopt disparate schemes for taxing alimony, both Austria and Germany may tax the same item of income without offering any relief for the other state's tax. Obviously, the imposition of tax by two member states on the same item of income hampers cross-border economic activity, and therefore does not promote Community integration goals. Thus, it would be desirable for member states to ensure that their autonomously drafted regulations and tax laws do not create conflicts with those of other states. But states' failure to coordinate their tax systems does not constitute discrimination.

The Court has handled nondiscriminatory barriers to market integration, such as failure to coordinate regulatory schemes with those of other states, under its "restriction" analysis.<sup>175</sup> The distinction between the ECJ's conceptions of discrimination and restriction is analogous to the distinction drawn by the U.S. Supreme Court in its Dormant Commerce Clause jurisprudence between discrimination and "undue burdens."<sup>176</sup> Although state regulation that discriminates against interstate trade is virtually invalid *per se* under the Commerce Clause of the U.S. Constitution, nondiscriminatory regulation may also violate the prohibition on "undue burdens" on interstate trade.<sup>177</sup> As with American jurisprudence, it is important to conceptually distinguish these two strains of European jurisprudence because the ECJ's standard of review for each differs. Although discrimination is virtually invalid *per se* in Europe, more public policy exceptions may be available to justify nondiscriminatory restrictions.<sup>178</sup> Moreover, the ECJ has thus far shown reluctance to apply restriction reasoning in tax cases, perhaps out of deference to member state tax autonomy.<sup>179</sup>

### C. *Identifying Discriminatory and Compensatory Taxation*

It may seem obvious that national differences in tax rates or the selection of the person taxable on alimony do not constitute discrimination, at least in a system that does not require harmonization of tax

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<sup>175</sup> See *infra* notes 201–210 and accompanying text.

<sup>176</sup> See, e.g., *Bibb v. Navajo Freight Lines, Inc.*, 359 U.S. 520, 529–30 (1959).

<sup>177</sup> See *id.* (invalidating under the Dormant Commerce Clause a nondiscriminatory state mudguard regulation that differed from the mudguard regulations of forty-five other states).

<sup>178</sup> See *infra* notes 201–210 and accompanying text.

<sup>179</sup> See *Kofler & Mason, supra* note 109, at 70–71.

rates and tax bases. But applying the internal consistency test to the difficult case of cross-border economic double tax relief shows that the test aids in the consideration of complex and non-obvious tax cases. Recall that in *In re Manninen*, decided by the ECJ in 2004, Finland taxed resident shareholders and resident companies, but it granted shareholder imputation credits only on dividends from resident companies.<sup>180</sup> If we assumed under the harmony constraint that every member state employed Finland's tax rules, corporate profits would always be taxed at both the corporate and shareholder levels, resulting in economic double taxation. Only domestic dividends, however, would be entitled shareholder imputation credits that relieved the shareholder level tax; cross-border dividends would remain subject to unrelieved economic double taxation.<sup>181</sup>

Thus, the internal consistency test shows that the tax disadvantage at issue in *Manninen* did not stem from disparities between the Finnish and Swedish tax systems. Rather, the economic double taxation of dividends inbound to Finland would persist even if every other member state applied the exact same tax law as Finland.<sup>182</sup> The persistence of systematic disadvantageous tax treatment for cross-border dividends in the face of hypothetical harmonization in *Manninen* tends to suggest that Finland discriminated against cross-border divi-

<sup>180</sup> Case C-319/02, 2004 E.C.R. I-7477, ¶¶ 6-11; see also *supra* notes 134-142 and accompanying text.

<sup>181</sup> The following table summarizes how \$100 in corporate profits would be treated when distributed to domestic and cross-border shareholders if every member state adopted the Finnish tax regime, as described in *Manninen*:

	Domestic Dividend	Cross-Border Dividend
a. Corporate profit	100	100
b. Corporate tax (30%)	(30)	(30)
c. Dividend	70	70
d. Shareholder tax (30%)	(21)	(21)
e. Shareholder imputation credit	21	0
f. Net shareholder tax (d plus e)	0	(21)
g. Total EU tax burden (b plus f)	30	51

The table shows that failing to grant shareholder imputation credits to cross-border dividends systematically disfavors them as compared to domestic dividends. Note that this example simplifies several aspects of the case, including by using round tax rates and ignoring gross-up issues and source state withholding. For more a precise numerical example, see Lari Hintsanen & Kennet Pettersson, *The Implications of the ECJ Holding the Denial of Finnish Imputation Credits in Cross-Border Situations to Be Incompatible with the EC Treaty in the Manninen Case*, 45 EUR. TAX'N 130, 135-37 (2005).

<sup>182</sup> See *supra* note 181.

dends, and that the ECJ should closely scrutinize Finland's exclusion of inbound dividends from economic double tax relief.

In this way, the harmony constraint gives the Court an overall (source and residence) perspective on how the income will be taxed, without requiring the Court to delve into the specifics of the tax laws of other member states. When the Court assumes that all twenty-seven member states have the same law as the defendant member state, only one state's law matters: that of the defendant. This means that in *Maninen*, when evaluating the compatibility of Finnish residence rules with EC law, the ECJ would apply Finnish source rules instead of Swedish source rules. This is helpful in at least two ways. First, because Finland would participate in the case, the Court is more likely to get an accurate report of Finnish tax law than Swedish tax law. Second, by eliminating Swedish law from the inquiry, the Court would avoid the risk that interactions between particular Swedish source rules and particular Finnish residence rules create the appearance of discrimination (for example, because there was a disparity that created a nondiscriminatory cross-border tax disadvantage) or obscure discrimination (for example, because Sweden compensated for Finland's discrimination). It thus should eliminate the risk that the same challenged tax law could be EC law-compliant with respect to some states but not others.

Thus, in addition to helping identify when disadvantages are due to disparities, because the harmony constraint simplifies the factual and legal situation under review, the internal consistency test may also help reduce errors in which the ECJ fails to discover discrimination because the tax disadvantage is hidden or otherwise compensated by the tax rules of the other state.<sup>183</sup> The test accomplishes this without introducing as much uncertainty as the overall approach.<sup>184</sup>

Recall that in the 2006 *Kerckhaert & Morres* case, adverse tax treatment by Belgium of inbound dividends was obscured by special tax benefits offered by France on outbound dividends.<sup>185</sup> France took the somewhat unusual step of granting shareholder imputation credits to foreign shareholders.<sup>186</sup> The imputation credit was sufficiently generous that even after the application of both French and Belgian taxation, the shareholders still paid less tax overall on dividends from a

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<sup>183</sup> See *supra* notes 99–111 and accompanying text.

<sup>184</sup> See *supra* notes 147–159 and accompanying text.

<sup>185</sup> See Case C-513/04, 2006 E.C.R. I-10967, ¶¶ 9–12; see also *supra* notes 99–111 and accompanying text.

<sup>186</sup> See *Kerckhaert & Morres*, 2006 E.C.R. I-10967, ¶¶ 9–12.



French company than they would have paid on Belgian dividends.<sup>187</sup> In his opinion in the case, Advocate General Geelhoed argued that the absence of a net cross-border disadvantage was dispositive: if there was no net tax disadvantage, there was no discrimination.<sup>188</sup>

Yet, had the Advocate General applied the harmony constraint, he would have assumed that Belgian law would apply both inbound and outbound. Because Belgium did not grant imputation credits to foreign shareholders, there would have been no compensatory tax benefit to obscure the adverse effects of Belgian taxation, and he would have been able to see that Belgian law created a net cross-border tax disadvantage whenever credits from the source state failed to compensate for Belgian tax.<sup>189</sup> Again, the persistence (or in this case, the appearance) of a cross-border tax disadvantage under the harmony constraint does not necessarily lead to the conclusion that Belgium discriminated. The Advocate General still might have concluded that Belgium did not discriminate, but in that case Belgium would have had to offer arguments explaining why the cross-border tax disadvantage did not constitute discrimination. Logically, the absence of a net cross-border tax disadvantage should not constitute a valid defense of the Belgian tax scheme because the absence of a cross-border tax disadvantage in Kerckhaert's and Morres' case was due to unilateral conferral of a tax credit by France, not any mitigating action by Belgium.

#### D. *An American Solution to a European Problem?*

Those familiar with state taxation in the United States may be amazed at the claim that anything helpful could be wrested from the U.S. Supreme Court's constitutional tax jurisprudence, which by the Court's own description is a "quagmire" and "tangled underbrush."<sup>190</sup> But the Supreme Court's troubles with tax discrimination stem principally from an ever-changing series of standards, not from use of the internal consistency test. Indeed, the internal consistency test is a rare oasis of logical rigor in an area otherwise aptly characterized as "con-

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<sup>187</sup> *Id.* ¶ 26-27 (opinion of Advocate General Geelhoed).

<sup>188</sup> *Id.*

<sup>189</sup> For a numerical example, see *supra* note 109 and accompanying text.

<sup>190</sup> See *Nw. States Portland Cement Co. v. Minnesota*, 358 U.S. 450, 457-58 (1959); see also *Wardair Canada Inc. v. Fla. Dept. of Revenue*, 477 U.S. 1, 17 (1986) (Burger, C.J., concurring in part and concurring in the judgment) (referring to "the cloudy waters of this Court's 'dormant Commerce Clause' doctrine").

fused.<sup>191</sup> As long as the ECJ does not import the profusion of conflicting U.S. judicial standards for tax discrimination along with the internal consistency test, it should be able to avoid the major pitfalls of the U.S. jurisprudence.

It is not surprising that a test developed by the U.S. Supreme Court for its state tax discrimination cases would also work for European tax discrimination cases because the problem of overlapping taxation exists in both jurisdictions. Crucially, both the U.S. Supreme Court and the ECJ have held that cross-border tax disadvantages due to tax disparities do not violate constitutional prohibitions on tax discrimination.<sup>192</sup> Thus, even if the American and European judicial standards for discrimination are not otherwise coextensive, the carve-out for disparities in each jurisdiction means that the internal consistency test can be applied in both places.<sup>193</sup>

Practical and structural differences between U.S. state taxation and EU member state taxation mean that the internal consistency test could be even more useful to the ECJ than to the U.S. Supreme Court. First, the stakes are higher in Europe than they are in the United States for at least two reasons. Member state income taxes represent a higher pro-

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<sup>191</sup> See Tracy A. Kaye, *Tax Discrimination: A Comparative Analysis of U.S. and EU Approaches*, 7 FLA. TAX REV. 47, 56 (2005).

State tax expert Professor Walter Hellerstein, although unconvinced that the internal consistency test added anything new to state tax discrimination standards previously elucidated by the U.S. Supreme Court, noted that “[a]s a matter of theory, it is difficult to quarrel with the proposition that the commerce clause forbids taxes that penalize taxpayers merely because they do business across state lines. And the ‘internal consistency’ doctrine may be viewed as a logical corollary to that proposition.” Hellerstein, *Internal Consistency I*, *supra* note 29, at 164. Recently, the Supreme Court seems to have narrowed the application of the internal consistency approach. See Hellerstein, *Internal Consistency II*, *supra* note 29, at 44–45 (analyzing *American Trucking Ass’n v. Michigan Public Service Commission*, 545 U.S. 429 (2005)), and concluding that internal consistency remains a relevant constitutional standard).

<sup>192</sup> See, e.g., *Moorman Mfg. Co. v. Bair*, 437 U.S. 267, 278 n.12 (1978) (refusing to strike down Iowa’s apportionment formula, even though the fact that Iowa’s apportionment formula differed from Illinois’s formula could result in double taxation of interstate commerce, because the tax disadvantage was due to “disparity”); Case C-403/03, *Schempp v. Finanzamt München*, 2005 E.C.R. I-6421, ¶ 34 (refusing to find discrimination where disparate impact resulted from differences in two member states’ tax treatment of cross-border alimony payments).

<sup>193</sup> In my view, and in the view of other commentators, the U.S. and EU substantive conceptions of tax discrimination are indeed remarkably similar, although that is not necessary for the internal consistency test to work in both jurisdictions. See Hellerstein et al., *supra* note 101 (comparing constitutional restraints on corporate tax integration in each jurisdiction); Kaye, *supra* note 191, at 111–31 (comparing U.S. Supreme Court and ECJ tax cases); Mason, *supra* note 45, at 120–28 (comparing normative justifications for U.S. and EU bans on tax discrimination).

portion of taxpayer's overall tax burden in Europe than do state taxes in the United States.<sup>194</sup> Also, market distortions from cross-border tax differences (whether caused by discriminatory taxes or nondiscriminatory disparities) are less significant in the United States than in Europe because U.S. states generally use the federal tax base as a starting point for their tax assessments.<sup>195</sup> This means that the tax bases of U.S. states are harmonized to a much greater extent than those of EU member states.

Second, application of the internal consistency test in the United States fails to capitalize on one of its principal virtues: that it eliminates the need to consider the source rules of one state in light of the residence rules of another state. This is because, for business taxation, U.S. states generally do not apply source and residence tax rules.<sup>196</sup> Instead, they allocate most taxable income according to the formulary apportionment method.<sup>197</sup> Under this method, a taxpayer's total ac-

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<sup>194</sup> U.S. taxpayers' federal income tax burden exceeds their state income tax burden because state tax rates are low compared to federal rates, and states apply their rates to tax bases similar to the federal tax base. There is no EC-level income taxation in Europe, so Europeans' tax burden consists primarily of national income taxes and value-added taxes. OECD WORLD FACTBOOK 179-80 (2005).

<sup>195</sup> JEROME R. HELLERSTEIN & WALTER HELLERSTEIN, STATE TAXATION ¶ 7 (3d ed. 1999 & Supp. 2007) (business taxation); *id.* ¶ 20 (personal taxation).

<sup>196</sup> *See id.* ¶ 7.02.

<sup>197</sup> *See generally* Hellerstein et al., *supra* note 101. The U.S. states allocate personal income according to source and residence rules, but the dominant method for business income is formulary apportionment, and only certain types of income not related to the taxpayers' business operations (e.g., portfolio interest and dividends) are taxed on a residence basis when they are not constitutionally subject to apportionment. *See id.* The method employed by the EU member states, using source and residence rules, is called the "arm's-length" or "separate accounting" method. *See generally id.* Formulary apportionment has been proposed for the EU under the name "common consolidated corporate tax base" ("CCCTB"). *See, e.g., Commission Working Paper on Common Consolidated Corporate Tax Base, CCCTB: Possible Elements of a Technical Outline (CCCTB/WP/057)* (July 26, 2007), available at [http://ec.europa.eu/taxation\\_customs/resources/documents/taxation/company\\_tax/common\\_tax\\_base/CCCTBWP057\\_en.pdf](http://ec.europa.eu/taxation_customs/resources/documents/taxation/company_tax/common_tax_base/CCCTBWP057_en.pdf); *see also Communication from the Commission to the Council, the European Parliament and the European Economic and Social Committee: Tackling the Corporation Tax Obstacles of Small and Medium-Sized Enterprises in the Internal Market—Outline of a Possible Home State Taxation Pilot Scheme*, at 8, COM (2005) 702 final (Dec. 23, 2005) [hereinafter *Tackling the Corporation Tax*]. For more on the formulary apportionment and arm's-length methods, see MICHAEL J. GRAETZ, FOUNDATIONS OF INTERNATIONAL INCOME TAXATION 400-21 (2003). For the EU proposal, see, for example, *Tackling the Corporation Tax, supra*, at 8. For a proposal that the United States unilaterally move from separate accounting to formulary apportionment for taxing the income of multi-national enterprises, see REUVEN S. AVI-YONAH & KIMBERLY A. CLAUSING, HAMILTON PROJECT DISCUSSION PAPER NO. 2007-08, REFORMING CORPORATE TAXATION IN A GLOBAL ECONOMY: A PROPOSAL TO ADOPT FORMULARY APPORTIONMENT 5 (2007), available at [http://www.brookings.edu/~media/Files/rc/papers/2007/06corporatetaxes\\_clausing/200706clausing\\_aviyonah.pdf](http://www.brookings.edu/~media/Files/rc/papers/2007/06corporatetaxes_clausing/200706clausing_aviyonah.pdf).

tive business income, wherever derived, is divided among the U.S. states according to the presence of factors of production in each state.<sup>198</sup>

#### IV. LIMITATIONS OF THE INTERNAL CONSISTENCY TEST

The internal consistency test represents a significant improvement on the methods currently used by the ECJ and those suggested by commentators, but it has certain limitations, which are discussed in this Part.

##### A. *Reprise: A Methodology, Not a Standard*

Although the internal consistency test addresses the major analytical problems caused by overlapping taxation, it does not, by itself, dispose of tax cases. A challenged member state tax law that "passes" the internal consistency test is not necessarily EC law-compliant. When a tax disadvantage passes the internal consistency test, the proper conclusion is that it was caused by a disparity.<sup>199</sup> This is useful information for the ECJ because disparities are not discriminatory.<sup>200</sup> Nonetheless, theoretically, a nondiscriminatory disparity could violate EC law if it "restricts" intra-Community commerce.<sup>201</sup>

The ECJ has never held a nondiscriminatory tax law to constitute such a restriction, but it has found non-tax regulations to constitute nondiscriminatory restrictions.<sup>202</sup> A restriction approach in tax cases would allow the Court to scrutinize cases in which member states "fix" discrimination in their tax codes by extending the application of the disadvantageous law to domestic taxpayers. Germany employed this approach when the ECJ held that German thin capitalization rules vio-

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<sup>198</sup> See, e.g., UNIFORM DIVISION OF INCOME FOR TAX PURPOSES ACT § 9 (1957). These factors generally include some combination of sales, payroll, and property. See *id.* (recommending equal weighting of those factors).

<sup>199</sup> See *supra* notes 169–174 and accompanying text.

<sup>200</sup> See *id.*; see also *supra* notes 74–98 and accompanying text.

<sup>201</sup> Cf. Case 120/78, *Rewe-Zentral AG v. Bundesmonopolverwaltung für Branntwein (Cassis de Dijon)*, 1979 E.C.R. 649, ¶ 15.

<sup>202</sup> See *id.* The distinction between discrimination and restriction in the EU is similar to that drawn by the U.S. Supreme Court under the Commerce Clause between discrimination and undue burdens. See, e.g., *Bibb v. Navajo Freight Lines, Inc.*, 359 U.S. 520, 529–30 (1959) (invalidating a nondiscriminatory state mudguard regulation that differed from the mudguard regulations of forty-five other states because it constituted an undue burden on interstate commerce under the Commerce Clause); see also Kofler & Mason, *supra* note 109, at 94–96 (comparing the EU concept of restrictions with the U.S. concept of undue burdens).

lated the EC Treaty because they applied only to German subsidiaries owned by foreign parent companies.<sup>203</sup> Rather than repeal its thin capitalization rules, Germany amended its law to extend the restrictive legislation to German subsidiaries of German parents.<sup>204</sup> Although applying the restrictive rule equally to resident and nonresident taxpayers may remove the discrimination, it keeps in place the restriction, which may disproportionately burden nonresident taxpayers. A robust conception of prohibited tax restrictions would take into account the disproportionate effect of facially neutral member state tax legislation.

It is uncertain whether the ECJ will apply a restriction analysis in future tax cases, and this Article offers no opinion on that question.<sup>205</sup> Adoption of a restriction approach to tax cases, however, might lead the Court to conclude that some disparities, although not discriminatory, nevertheless violate EC law by inhibiting cross-border commerce. The possibility that disparities might violate EC law would mean that "passing" the internal consistency test would not immunize a member state's law from EC law challenges.

Likewise, a failure of internal consistency does not lead inexorably to the conclusion that the member state discriminated. Failure of internal consistency shows only that the disadvantage does not derive from disparities. But not all such disadvantages are discriminatory. For example, they could be justified by differences in the situations of cross-border and internal taxpayers.<sup>206</sup> Or they could be justified for public policy reasons, such as the need to prevent tax fraud.<sup>207</sup> Thus,

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<sup>203</sup> See Case C-324/00, Lankhorst-Hohorst GmbH v. Finanzamt Steinfurt, 2002 E.C.R. I-11779, ¶ 44.

<sup>204</sup> Umar Thömmes, *Commission's Reluctance and Member States' Overreactions—A Perfect Recipe for Chaos*, 32 INTERTAX 124, 125 (2004).

<sup>205</sup> The ECJ has used restriction language in tax cases that also involved discrimination. See, e.g., Case C-446/03, Marks & Spencer plc v. Halsey, 2005 E.C.R. I-10837, ¶¶ 28–34 (holding that the United Kingdom's refusal to offset British income with losses of foreign subsidiaries in cases where those foreign losses could not be taken in the subsidiary's state restricted the British parent's freedom of establishment); cf. Case C-250/95, Futura Participations SA v. Administration des Contributions, 1997 E.C.R. I-2471, ¶ 43 (holding that a nondiscriminatory tax accounting burden placed on nonresidents to keep an extra copy of their books in the host state was restrictive). For commentary on the ECJ's restriction approach in tax cases, see Axel Cordewener, *The Prohibitions of Discrimination and Restriction Within the Framework of the Fully Integrated Internal Market*, in EU FREEDOMS AND TAXATION (Frans Vanistendael ed., 2006) (concluding that the Court's tax restriction cases could be recast as discrimination cases); Graetz & Warren, *supra* note 14, at 1199; Mason, *supra* note 14, at 91–95; Frans Vanistendael, *The Compatibility of the Basic Economic Freedoms with the Sovereign National Tax Systems of the Member States*, 12 EC TAX REV. 136, 137–38 (2003).

<sup>206</sup> See generally MASON, *supra* note 4.

<sup>207</sup> See *id.* at 93–114.

failure of internal consistency does not necessarily lead to the conclusion that there has been tax discrimination because that conclusion depends on how the ECJ defines tax discrimination.<sup>208</sup>

As a result, the internal consistency test does not eliminate the need for the ECJ to apply its standard for discrimination in tax cases. Therefore, if the ECJ's tax discrimination standard suffers from defects, those defects would not be resolved by the internal consistency test.<sup>209</sup> Adoption of the internal consistency test, however, should not produce new flaws in the standard—any such flaws are independent of the selection of a methodology to address the overlapping tax dilemma.

If the ultimate effect of the internal consistency test is that the Court applies its discrimination standard *more* often,<sup>210</sup> the internal consistency test could make any defects in the Court's standard more pronounced. On the other hand, to the extent that the internal consistency test filters out cases of disparity, to which the ECJ need not apply discrimination analysis, then use of the test would lead the Court to apply its discrimination standard *less* often, thereby minimizing the impact of any defects in the discrimination standard. In either case, any problems with the discrimination standard applied by the ECJ are independent of its approach to the overlapping tax dilemma, be it internal consistency, per-country, or overall.

### B. *Fixing the Counterfactual Antecedents*

The internal consistency test might be criticized for being hypothetical.<sup>211</sup> The harmony constraint does not obtain in reality, so the Court must engage in counterfactual reasoning. How should the Court determine the scope of the counterfactual? What, precisely, does it mean to assume that all the other member states apply the challenged rule? Under the harmony constraint, is the challenged tax rule defined as narrowly as possible, and then universalized to all the other states? What else about the other states' tax systems would also have to change

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<sup>208</sup> For critical evaluation of the standard applied by the ECJ in tax discrimination cases, see, for example, Graetz & Warren, *supra* note 14.

<sup>209</sup> Although I have elsewhere criticized the Court's tax discrimination standard, see generally Mason, *supra* note 45, such criticism is not the goal of this Article.

<sup>210</sup> This could happen if, under internal consistency, the Court applies its discrimination standard in cases it previously would have erroneously concluded were disparities or in cases where the other member state compensated for the discrimination.

<sup>211</sup> Cf. Hellerstein, *Internal Consistency I*, *supra* note 29, at 143, 165 (criticizing the U.S. version of internal consistency for being hypothetical, but not citing any adverse consequences that derive from the hypothetical nature of the test).

to make the counterfactual true? Or does the harmony constraint mean something broader, for example that every member state should be assumed to have *all* the same tax laws as the defendant member state? The problem of fixing the counterfactual antecedents could reintroduce some of the uncertainty seen in the overall approach.<sup>212</sup>

The U.S. experience shows, however, that fixing the counterfactual antecedents has not posed a serious problem.<sup>213</sup> Additionally, the ECJ's tax rulings are already significantly hypothetical.<sup>214</sup> The ECJ does not sit as an appellate court in tax cases; rather, it answers preliminary questions referred by national courts faced with tax issues touching upon EC law.<sup>215</sup> The preliminary ruling procedure necessarily results in abstract analysis by the ECJ, which posits a stylized complaining taxpayer and compares that taxpayer to a stylized internal taxpayer.<sup>216</sup>

The benefits of the internal consistency test more than compensate for the increase in abstraction in an already quite abstract process. Although the scope of the harmony constraint might be subject to debate, and commentators may disagree as to whether it was applied correctly in a particular case, at least it is a more transparent and reliable methodology than the per-country and overall approaches currently employed by the Court.<sup>217</sup>

### C. *Not Applicable in Most Favored Nation Cases*

A minor shortcoming of the internal consistency test is that it cannot easily be applied to cases in which the taxpayer argues that the EC Treaty implies a most favored nation obligation.<sup>218</sup> Taxpayers raise most favored nation claims when a member state grants better treatment (usually in a tax treaty) to residents of one member state than to resi-

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<sup>212</sup> Philosophers have long contemplated the counterfactual antecedent problem. See, e.g., NELSON GOODMAN, *FACT, FICTION AND FORECAST* 16 (1979).

<sup>213</sup> See, e.g., *Okl. Tax Comm'n v. Jefferson Lines, Inc.*, 514 U.S. 175, 185 (1995).

<sup>214</sup> See Case C-204/90, *Bachmann v. Belgium*, 1992 E.C.R. I-249, ¶¶ 11, 35 (assuming member states have a given tax policy).

<sup>215</sup> See ANNUAL REPORT 2006, *supra* note 23, at 90. Of the thirty-four new tax cases listed in the 2006 Annual Report, twenty-seven were references for a preliminary ruling and seven were direct actions. *Id.*

<sup>216</sup> For criticism of the ECJ's "comparable internal situation test," see generally Mason, *supra* note 45.

<sup>217</sup> See *supra* notes 122-145 and accompanying text.

<sup>218</sup> See, e.g., Case C-376/03, *D. v. Inspecteur van de Belastingdienst*, 2005 E.C.R. I-5821, ¶ 63.

dents of another.<sup>219</sup> Thus, rather than preferring its own residents to nonresidents, the member state prefers some nonresidents to other nonresidents. Because the criterion for granting the tax preference in these cases is nationality, or a proxy for nationality such as tax residence, they raise nationality discrimination concerns.<sup>220</sup> But a national rule that says “nonresidents from Greece will be taxed more favorably than nonresidents from Italy” is not susceptible to universalization.<sup>221</sup> How would the harmony constraint be applied in Greece? In Italy?

Arguably, the fact that a member state’s rule cannot be universalized is itself evidence that it is discriminatory, although such discrimination could be justified by differences between taxpayers of different states, or for public policy reasons, such as the need to limit reciprocal benefits secured in bilateral tax treaties to the parties to the treaty. Nevertheless, the inapplicability of the internal consistency test to most favored nation cases probably does not represent a significant shortcoming because the Court already held in the 2005 case *D. v. Inspecteur van de Belastingdienst* that the EC Treaty does not imply a most favored nation requirement for member state tax treaties.<sup>222</sup> If it is true, however, that the inability to universalize a member state tax law is probative of its discriminatory character, then the Court should have subjected the tax treaty provision in *D.* to heightened scrutiny.

#### D. Embedded Conditional Language

A final criticism of the internal consistency test is that it is gameable by the member states. Suppose Spain granted Spanish taxpayers a certain tax benefit, but it would only grant nonresident taxpayers the benefit if all other member states granted Spanish taxpayers the same benefit. By conditioning similar treatment for nonresidents on the demand for EU-wide reciprocity, has Spain satisfied the internal consistency test? The answer appears to be yes: when the Spanish rule is universalized under the harmony constraint, the condition for Spain to grant benefits to nonresidents is fulfilled, so residents and nonresidents would both receive benefits. Under ordinary conditions, however, the reciprocity requirement might not be satisfied, and nonresidents would be denied the tax benefit.

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<sup>219</sup> See, e.g., *id.*

<sup>220</sup> See, e.g., *id.*

<sup>221</sup> I realize that no national law is phrased in these terms, but having different tax treaty terms for nationals of different member states could be functionally equivalent to my phrasing.

<sup>222</sup> See *D.*, 2005 E.C.R. I-5821, ¶ 63.



Before concluding that it is not necessary to worry about this rather obvious form of manipulation, consider the 1981 U.S. Supreme Court case *Western & Southern Life Insurance Co. v. State Board of Equalization of California*.<sup>223</sup> There, California imposed a "retaliatory" tax on out-of-state insurance companies operating in California, but only if the company's home state imposed a similar tax on California insurers doing business in that state.<sup>224</sup> The Supreme Court held that conditioning favorable tax treatment for out-of-state insurers upon reciprocal treatment of California companies by other states did not violate the Equal Protection Clause.<sup>225</sup> In a subsequent case, the Court explained its reasoning in *Western & Southern*: California did not violate the Equal Protection Clause because its "purpose in enacting the retaliatory tax—to promote interstate business of domestic insurers by deterring *other States* from enacting discriminatory or excessive taxes—was a legitimate one."<sup>226</sup> Thus, under the Equal Protection Clause, the motivation for the state's reciprocity requirement served as important factor for determining its constitutionality.

The ECJ's attitude towards tax reciprocity requirements has been mixed.<sup>227</sup> Early on in its jurisprudence, the ECJ rejected member states' arguments that reciprocal tax arrangements, including those formalized in tax treaties, should be immune from scrutiny under the nondiscrimination standard.<sup>228</sup> Instead, the Court held in several cases that member states were required to extend on a unilateral basis tax bene-

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<sup>223</sup> 451 U.S. 648 (1981).

<sup>224</sup> *Id.* at 650.

<sup>225</sup> *Id.*

<sup>226</sup> *Metro. Life Ins. Co. v. Ward*, 470 U.S. 869, 876–77 (1985) (citing *Western & Southern*, 451 U.S. at 668) (distinguishing California's tax in *Western & Southern* from a higher tax rate imposed by Alabama on premiums paid to out-of-state insurers). The Supreme Court's holding in *Western & Southern* is attributable to the standard of review applied in the case. The Court did not analyze California's tax under the Dormant Commerce Clause because Congress consented to state regulation of insurance under the McCarran-Ferguson Act. *See id.* at 880. Thus, California's tax was given only rational basis review under the Equal Protection Clause. *See id.* at 881. In contrast, when the Supreme Court considered a discriminatory tax with an element of reciprocity under the Commerce Clause, it struck the tax down. *See New Energy Co. of Ind. v. Limbach*, 486 U.S. 269, 280 (1988) (striking down as discriminatory an Ohio ethanol credit that was limited to ethanol produced in Ohio or in other states that granted Ohio ethanol producers a similar credit).

<sup>227</sup> Compare Case C-307/97, *Compagnie de Saint-Gobain, Zweigniederlassung Deutschland v. Finanzamt Aachen-Innenstadt*, 1999 E.C.R. I-6161, ¶¶ 55–63, with *D.*, 2005 E.C.R. I-5821, ¶ 63.

<sup>228</sup> *See Compagnie de Saint-Gobain*, 1999 E.C.R. I-6161, ¶¶ 55–63.

fits previously bestowed to nonresidents only on a reciprocal basis.<sup>229</sup> But more recently, the ECJ rejected the argument that the EC Treaty implied a general most favored nation requirement for tax treaties.<sup>230</sup>

The rarity of such reciprocal (or retaliatory) taxes in the United States, despite the Supreme Court's use of the internal consistency test, suggests that the risk that states will game the test is not significant. Nevertheless, if the member states gamed the internal consistency test by embedding conditional language in their tax laws, the ECJ could find such provisions to violate EC law because they constitute impermissible "restrictions" on intra-Community commerce, even though hypothetical harmonization shows that they are technically disparities. In the alternative, such conditional language could be deleted from the statute before it is universalized under the internal consistency test to approximate the result of the rule in cases where the condition is unfulfilled.

#### CONCLUSION

As the number of tax cases in the European Court of Justice increases, the need to address problems created for the Court by overlapping taxation of cross-border income becomes more urgent. This Article argues that the internal consistency test would help prevent two kinds of judicial errors in tax discrimination cases. One type of error occurs when the ECJ fails to recognize that cross-border disadvantages arise from disparities, not discrimination; another type occurs when the ECJ fails to discover discrimination because compensatory taxes in one state obscure the cross-border tax disadvantage caused by another state's discrimination.

Respect for member state fiscal sovereignty requires the Court to avoid the first type of error, the false positive. By entering into the EC Treaty, the member states agreed not to use their tax systems to discriminate against nationals of other member states, but the states retained autonomy over the substantive aspects of their tax systems, such as the ability to set tax rates and define tax bases.<sup>231</sup> When the ECJ mistakes disparity for discrimination, it exceeds its institutional competence by invalidating tax laws that are not inconsistent with the EC

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<sup>229</sup> See, e.g., *id.* (holding that a member state must grant to permanent establishments of EU companies benefits equivalent to those available under tax treaties to resident companies).

<sup>230</sup> *D.*, 2005 E.C.R. I-5821, ¶ 63.

<sup>231</sup> See, e.g., Case C-336/96, *Gilly v. Directeur des Services Fiscaux du Bas-Rhin*, 1998 E.C.R. I-2793, ¶¶ 24, 30, 34, 46, 48.

Treaty, thereby unnecessarily narrowing the member states' methods for raising revenue and accomplishing tax policy objectives.<sup>232</sup> As the debate over whether the ECJ should retain jurisdiction to review tax cases shows, the member states recognize and resist such judicial encroachment on their tax powers.<sup>233</sup> By supplying the ECJ a reliable method to determine whether a cross-border tax disadvantage was caused by disparities between the two states' tax systems, the internal consistency test would help the Court show national tax laws proper deference.

The internal consistency test also would help the ECJ avoid the second type of error, the false negative, by highlighting when compensatory taxes offered by one member state obscure discrimination by another member state. Respect for the rights of EC taxpayers and promotion of European economic integration and tax competition depend on the Court's ability to recognize and censure even obscure cases of tax discrimination.

Finally, the internal consistency test provides an elegant solution to what seemed to be the intractable problem of whether the ECJ should adopt the per-country or overall approach in tax cases. It gives the ECJ a broad (source and residence) perspective on cross-border tax situations without requiring the Court to discover (or speculate about) the tax laws of any member state other than the defendant. The ECJ's growing tendency to look at the tax situation in other member states is both perilous and inappropriate. It is perilous because it adds complexity and therefore increases the probability of error, and it is inappropriate because the legality of one member state's tax law should not be determined with respect to another's. A member state should not be able to justify its own tax discrimination by pointing to an offsetting advantage enjoyed by the taxpayer in his or her home state.

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<sup>232</sup> See, e.g., Graetz & Warren, *supra* note 14, at 1208-13 (criticizing the demise, via decisions by the ECJ, of shareholder imputation in Europe).

<sup>233</sup> See Vanistendael, *supra* note 15, at 413.