The Direct Income Tax Case Law of the European Court of Justice: Past Trends and Future Developments

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I. Introduction

Since the early 1950's Europe has been engaged in a politically motivated integration process that seeks to tie the economic, social, and political structures of the European States so closely together that they cannot afford to enter into armed conflict with each other. The economic side of this integration process involves both market integration (implying rights to free movement and nondiscrimination for economic operators) and streamlining of the regulatory systems of the Member States (harmonization of laws and coordination of policies).

Interestingly, in view of the strong political motivation, the founding fathers of the European Community placed the responsibility for the economic integration process in the hands of a newly created European governance structure, in which a European legislator was given the task of eliminating nondiscriminatory restrictions to market integration that result from disparities between regulatory systems (positive integration by means of harmonization). The European judiciary, for its part, was given the task of upholding private sector rights to exercise demand and supply across borders and on equal terms as those applicable to local market competitors (negative integration, rights to free movement, and nondiscrimination).

Within this constitutional context, the European legislator has deepened and widened the integration process, so that the European Union now has twenty-seven Member States fully engaged in an integration process with an economic pillar (internal market, economic and monetary union with a single currency, common and coordinated socio-economic policies), a foreign policy pillar (European foreign, se-

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curity, and defense policy),[1] and a home affairs pillar (European policy as regards justice, liberty, and security).[2] For its part, the European Court of Justice (the court) has ensured a constitutionally guaranteed minimum of economic integration, by widely interpreting the directly applicable and overriding rights to equal treatment and free movement that private sector economic operators enjoy in the internal market.[3] This was a logical development within the political and legal context of the EC Treaty,[4] because without private sector, cross-border economic activity there is no economic integration between mixed economies. In particular, in the early 1970's, when the legislative program came to a virtual standstill as a result of the economic crisis, the court interpreted the EC Treaty as prohibiting overt discrimination on grounds of origin and nationality, and also covert discrimination, on the basis of any criterion the use of which works in particular against cross-border situations.[5] In addition to this broad discrimination based-reading of the EC Treaty (principle of equality), it also developed a wider "restriction-based" reading of the EC Treaty (principle of liberty), under which any host state measure that is capable of restricting market access, regardless of whether or not applied in a discriminatory way, is prohibited by the EC Treaty unless it serves an overriding public interest objective.[6] The court thus prevented Member States from imposing unnecessary double burdens as a pro-

[1] See Council of Ministers, The Common Foreign and Security Policy, http://www.consilium.europa.eu/showpage.aspx?id=248&lang=en (last visited Mar. 1, 2009); Council of Ministers, European Security and Defense Policy, http://www.consilium.europa.eu/showpage.aspx?id=261&lang=en (last visited Mar. 1, 2009).

[2] See Bernd Martenczuk & Servaas van Thiel, Justice, Liberty, Security: New Challenges for EU External Relations (2008); The Origins and Development of the EU (Fact Sheet No. 1, Jan. 2008), available at http://www.eu-upplysningen.se/upload/dokument/Trycksaker/eng_faktablad_1_080206_webb.pdf.

[3] Case law can be found at the website of the European Court of Justice. See European Court of Justice, Case Law, http://curia.europa.eu/en/content/juris/index.htm (last visited Mar. 1, 2009).

[4] See Treaty Establishing the European Economic Community, Mar. 27, 1957, 298 U.N.T.S. 11 (entered into force Jan. 1, 1958) (establishing the European Community). The treaty was amended by the Treaty of Amsterdam, Amending the Treaty on European Union, the Treaties Establishing the European Communities and Certain Related Acts, Oct. 2, 1997, 1997 O.J. (C 340), 1. The Treaty was amended last by the Treaty of Nice, amending the Treaty on European Union, The Treaties Establishing the European Communities and Certain Related Acts, Mar. 10, 2001, 2001 O.J. (C 80) 1. For the current treaty, see Consolidated Version of the Treaty Establishing the European Community, Dec. 29, 2006, 2006 O.J. (C 321E) 37, available at http://eur-lex.europa.eu/LexUriServ/LexUriServ.Do?uri=OJ:C:2006:321E:0001:0331:EN:pdf [hereinafter EC Treaty].

[5] For a prohibition of different treatment on grounds of residence, see Case 152/73, Sotgiu v. Deutsche Bundespost, 1974 E.C.R. 153, ¶ 11.

[6] See Case 120/78, Rewe-Zentral AG v. Bundesmonopolver Waltung für Branntwein (*Cassis de Dijon*), 1979 E.C.R. 649, ¶ 8; Case 8/74, Procureur du Roi v. Dassonville, 1974 E.C.R. 837, ¶ 7.

tectionist alternative to discrimination, and it obliged them to recognize home state standards.[7]

From the early days of the integration process, Europe has been particularly interested in removing tax obstacles to the internal market, because it is common knowledge that taxes are an important determinant of economic behavior.[8] Cross-border movements of products, labor, services, and capital for instance are responsive to differences in the effective tax burden that may result from different ways in which the same activity is taxed in two different Member States (disparities or tax differentials between regulatory systems to be harmonized away by the legislator), or from different tax treatment by one Member State of similar domestic and cross-border activities (discrimination to be removed by the judiciary).

In the area of indirect taxes, the EC Treaty explicitly instructs the European legislator to harmonize the laws of the Member States[9] and this has resulted in a deep harmonization process that has been successful in removing the main indirect tax obstacles to intra-Community trade.[10] Likewise, the EC Treaty explicitly prohibits indirect tax discrimination against products from other Member States,[11] and this provision has given rise to a significant body of case law.

In the direct tax area, however, there is neither an explicit prohibition of direct tax discrimination nor an explicit instruction to the Community legislator to act in this area. Unsurprisingly, the legislator has been very modest in removing direct tax disparities, in part because any Community action can be adopted only by unanimity (sovereignty lock on harmonization).[12] This is unlikely to change in the near future, because Member States consider income taxes as one of the few remaining policy instruments at their disposal, and several Member States expressed strong "red line" positions during the negotiations over the European "Constitution" and its successor "Reform Treaties" on the suggestion to introduce qualified majority voting in the tax area.[13]

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[7] Communication from the Commission Concerning the Consequences of the Judgment Given by the Court of Justice on 20 February 1979 in Case 120/78 ("Cassis de Dijon"), 1980 O.J. (C 256) 2.

[8] See, e.g. Martin Feldstein, Effects of Taxes on Economic Behavior, 61 Nat'l Tax J. 131 (2008).

[9] EC Treaty, note 4, art. 93.

[10] See VAT Harmonisation in the EU and Unfinished Business (Servaas van Thiel ed., 2008).

[11] EC Treaty, note 4, art. 90.

[12] Id. arts. 95, ¶ 2, 190, ¶ 5.

[13] During the negotiations on the Lisbon Treaty several Member States, including Ireland and the United Kingdom, indicated that they would never accept qualified majority voting in the tax area. The U.K. Minister for Europe, Jim Murphy, reiterated the well-known U.K. position as follows:

It is a fact, therefore, that after fifty years of European integration, the (corporate) income tax position of European citizens and companies is still determined mostly by the national laws of the Member States, and, to the extent these taxpayers engage in cross-border activities, by the tax treaties concluded by the state of residence of the taxpayer. When exercising their taxing powers, Member States have continued to rely on the Organisation for Economic Co-operation and Development (OECD) principles,[14] which mainly seek to allocate tax jurisdiction between states and avoid double taxation, without necessarily including the free movement and nondiscrimination guarantees required in a deep economic integration process.

It is also a fact that for almost thirty years European law and national income tax law developed in almost total isolation from each other, because there was some vague and widespread notion that there was a carve-out or sovereignty exception for income taxes in Community law. Once rejected by the court, however, implicitly in *Commission v. France*[15] (Avoir Fiscal) and explicitly in *Finanzamt Köln-Alstadt* v. *Schumacker*,[16] taxpayers increasingly have questioned the compatibility of Member States' tax (treaty) measures with taxpayers' directly applicable European rights to free movement and nondiscrimination. Or in other words, taxpayers increasingly have confronted Member States with the reality that they were collecting taxes illegally.

In the large body of income tax case law that developed over the last twenty years a broad cyclical pattern can be discerned[17] in which the court has indeed been hesitant to fully apply directly applicable

> The Government will not accept a Treaty which transfers power away from the UK on issues of fundamental importance to our sovereignty. The agreement reached at the June European Council reflects the "red lines" set out by the UK. At the Council, we made clear that we wanted a Treaty without constitutional characteristics. And we stated clearly that: Firstly, we would not accept anything in a new Treaty which required us to change our existing labour and social legislation; Secondly, we would protect our common law system and our police and judicial processes; Thirdly, we would maintain an independent foreign and defence policy; And fourthly we would protect our tax and social security system.

Jim Murphy, U.K. Minister for Europe, U.K. Approach to the Inter Governmental Conference 2007, Speech Before the U.K. House of Commons (July 25, 2007), available at http://www.fco.gov.uk/en/newsroom/latest-news/?view=Speech&id=1892854.

[14] See, e.g., Case C-336/96, Gilly v. Directeur des Services Fiscaux du Bas-Rhin, 1998 E.C.R. I-2793, ¶ 24 (recognizing that Member States have based many conventions on OECD principles). Bilateral tax treaties between European States can be found in IBFD, Tax Treaties Database, http://ip-online2.ibfd.org/treaty (last visited Mar. 1, 2009).

[15] Case 270/83, Commission v. France (*Avoir Fiscal*), 1986 E.C.R. 273.

[16] Case C-279/93, Finanzamt Köln-Altstadt v. Schumacker, 1995 E.C.R. I-225, ¶ 24.

[17] See the Internal Market and Direct Taxation: Is the European Court of Justice Taking a New Approach? (Servaas van Thiel ed., 2007).

Community law in an initial phase,[18] only to arrive at a long intermediate period, lasting from the early 1990's until 2005, in which it has been routinely applying internal market principles in the direct tax area.[19] Since 2005, however, the court seems to have returned to a more prudent phase.[20]

The objective of this Article is to sketch the large trends that can be discerned in the direct income tax case law of the ECJ and to place these in their proper constitutional context so as to explore possible future developments and to respond to criticisms that have appeared in the literature recently.[21]

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[18] See Case C-112/91, Werner v. Finanzamt Aachen-Innenstadt, 1993 E.C.R. I-429; Case C-204/90, Bachmann v. Belgium, 1992 E.C.R. I-249; Case C-69/88, H. Krantz GmbH & Co. v. Ontvanger der Directe Belastingen, 1990 E.C.R. I-583; Case 81/87, The Queen v. H.M. Treasury, ex parte Daily Mail, 1988 E.C.R. 5483.

[19] See Case C-330/91, The Queen v. Inland Revenue Commissioners, ex parte Commerzbank AG, 1993 E.C.R. I-4017; see also Case C-319/02, Manninen, 2004 E.C.R. I-7477; Case C-9/02, De Lasteyrie du Saillant v. Ministère de l'Économie, des Finances et de l'Industrie, 2004 E.C.R. I-2409; Case C-234/01, Gerritse v. Finanzamt Neukölln-Nord, 2003 E.C.R. I-5933; Case C-422/01, Försäkringsaktiebolaget Skandia v. Riksskatteverket, 2003 E.C.R. I-6817; Case C-324/00, Lankhorst-Hohorst GmbH v. Finanzamt Steinfurt, 2002 E.C.R. I-11779; Case C-168/01, Bosal Holding BV v. Staatssecretaris van Financiën, 2003 E.C.R. I-9409; Case C-385/00, De Groot v. Staatssecretaris van Financiën, 2002 E.C.R. I-11819; Case C-136/00, Danner, 2002 E.C.R. I-8147; Joined Cases C-397/98 and C-410/98, Metallgesellschaft Ltd. & Hoechst AG v. Commissioners of Inland Revenue & H.M. Attorney Gen., 2001 E.C.R. I-1727; Case C-251/98, Baars v. Inspecteur der Belastingdienst Particulieren, 2000 E.C.R. I-2787; Case C-35/98, Staatssecretaris van Financiën v. Verkooijen, 2000 E.C.R. I-4071; Case C-311/97, Royal Bank of Scotland plc v. Greece, 1999 E.C.R. I-2651; Case C-307/97, Compagnie de Saint-Gobain, Zweigniederlassung Deutschland v. Finanzamt Aachen-Innenstadt, 1999 E.C.R. I-6161; Case C-279/93, Finanzamt Köln-Altstadt v. Schumacker, 1995 E.C.R. I-225.

[20] See Case C-524/04, Test Claimants in the Thin Cap Litig. v. Commissioners of Inland Revenue, 2007 E.C.R. I-2107; Case C-374/04, Test Claimants in Class IV of the ACT Group Litig. v. Commissioners of Inland Revenue, 2006 E.C.R. I-11673; Case C-446/04, Test Claimants in the FII Group Litig. v. Commissioners of Inland Revenue, 2006 E.C.R. I-11753; Case C-513/04, Kerckhaert & Morres v. Belgium, 2006 E.C.R. I-10967; Case C-446/03, Marks & Spencer plc v. Halsey, 2005 E.C.R. I-10837; Case C-376/03, D. v. Inspecteur van de Belastingdienst, 2005 E.C.R. I-5821; Case C-8/04, Bujura v. Inspecteur van de Belastingdienst Limburg, 2004 O.J. (C 59) 17, subsequently removed from register by Order of the President of the Fourth Chamber of the Court of Justice of the European Communities, 2006 O.J. (C 60) 32; see also The Internal Market and Direct Taxation, note 17.

[21] Authors who are particularly critical of the ECJ include Michael Graetz, Alvin Warren, and Peter Wattel. See Michael J. Graetz & Alvin C. Warren, Income Tax Discrimination and the Political and Economic Integration of Europe, 115 Yale L.J. 1186, 1220 (2006); Peter J. Wattel, Commentary, Judicial Restraint and Three Trends in the ECJ's Direct Tax Case Law, 62 Tax L. Rev. 207 (2008). Other recent contributions on this subject include A Vision of Taxes Within and Outside European Borders: Festschrift in honor of Frans Vanistendael (Luc Hinnekens & Philippe Hinnekens eds., 2008); Comparative Fiscal Federalism: Comparing the European Court of Justice and the US Supreme Court's Tax Jurisprudence (Reuven S. Avi-Yonah, James R. Hines Jr. & Michael Lang eds., 2007); Cécile Brokelind, Towards a Homogeneous EC Direct Tax Law: Assessment of the Member States' Responses to the ECJ Case Law (2007); Paul Farmer & Adam Zalinski, General Report: Direct Tax Rules and the EU Fundamental Freedoms (2006), available at http://

The Article discusses key topics concerning the three main questions that have been addressed by the court in its direct tax cases. Under what conditions does Community law apply to a certain tax case (Part II)? When does a contested tax measure of a Member State constitute an internal market incompatible restriction (Part III)? When is that Member State nevertheless allowed, for overriding public interest reasons, to continue to apply that restrictive tax measure (Part IV)? Part V summarizes the main findings and responds to criticisms recently voiced against the ECJ in the literature.

II. Taxpayer Access to Community Law

A. *Taxpayers Have Broad Access to Community Law*

It is settled case law that though Member States are competent in the income tax area, they must exercise that competence in accordance with Community law.[22] Taxpayers are therefore not a priori excluded from Community law protection and there is no sovereignty exception for direct taxes,[23] even though there are some incidental nuances to the court's clear cut rejection of the sovereignty exception. In fact in certain politically sensitive cases the court either ruled the case outside the scope of Community law,[24] or simply ignored a

www.fide2006.org/GENERAL%20REPORT,%20TOPIC%201.pdf; Georg Kofler, Doppelbesteuerungsabkommen und Europäisches Gemeinschaftsrecht (2007); Jacques Malherbe, Phillippe Malherbe, Isabelle Richelle & Edoardo Traversa, The Impact of the Rulings of the European Court of Justice in the Area of Direct Taxation (Pol'y Dep't of the European Parliament, Mar. 2008); Ben J.M. Terra & Peter J. Wattel, European Tax Law (5th ed. 2008); Ruth Mason, Flunking the ECJ's Tax Discrimination Test, 46 Colum. J. Transnat'l L. 72 (2007); Frans Vanistendael, The ECJ at the Crossroads: Balancing Tax Sovereignty Against the Imperatives of the Single Market, 46 Eur. Tax'n 413 (2006).

[22] See Case C-279/93, Finanzamt Köln-Altstadt v. Schumacker, 1995 E.C.R. I-225, ¶ 21 (indicating for the first time in the ECJ's income tax case law that even though Member States are competent in the tax area, they must exercise that competence in accordance with Community law). This rule from *Schumacker* is repeated in practically every subsequent tax decision.

[23] See Case 270/83 Commission v. France (*Avoir Fiscal*), 1986 E.C.R. 273, ¶ 26 (implicitly rejecting the argument that Community law would not apply in the income tax area). For an analysis of the sovereignty exception and a discussion of case law beyond *Commission v. France* and *Schumacker*, see Servaas van Thiel, Free Movement of Persons and Income Tax Law: The European Court in Search of Principles 147-75 (2002).

[24] See Case 81/87, The Queen v. H.M. Treasury, ex parte Daily Mail, 1998 E.C.R. 5483, ¶ 25. Companies can not invoke Community law to switch jurisdiction until Member States have concluded an Article 220 Convention on emigration without losing legal personality. See EC Treaty, note 4, art. 220 (as in effect in 1984) (now Article 293); Case C-210/06, Cartesio Oktató és Szolgáltato-Betéti Társaság, 2008 E.C.R.____, available at http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:62006J0210:EN:HTML; *Daily Mail*, 1998 E.C.R. 5483, ¶ 21; see also *Werner*, 1993 E.C.R. I-429, ¶ 17. A German national residing in the Netherlands but working in Germany can not rely on Community law to obtain the right to deduct expenses in Germany because he is in a purely domestic situation even though he crosses the border twice a day to go to work. This issue was

question of interpretation of Community law.[25]

Apart from these "emergency breaks" for politically sensitive cases, however, taxpayers have broad access to the directly applicable rights to free movement and nondiscrimination. They generally need to be qualifying natural or legal persons, who are engaged in an intra-Community situation,[26] that is cross border[27] and either has economic substance[28] or a citizenship dimension.[29]

B. *Away from the Sovereignty Exception, But Not Quite for Tax Treaties*

In spite of the fact that Community law provides no carve-out or sovereignty exception for direct taxes, the court over time has developed a more structural hesitation in its direct tax case law to go be-

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subsequently settled in favor of the taxpayer in Case C-336/96, Gilly v. Directeur des Services Fiscaux du Bas-Rhin, 1998 E.C.R. I-2793, and Case C-385/00, De Groot v. Staatssecretaris van Financiën, 2002 E.C.R. I-11819.

25 The ECJ ignored discrimination issues involving more than two Member States in *Columbus Container* and *Metallgesellschaft & Hoechst.* See C-298/05, Columbus Container Servs. BVBA & Co. v. Finanzamt Bielefeld-Innenstadt, 2007 E.C.R. I-10451; Joined Cases C-397/98 and C-410/98, Metallgesellschaft Ltd. & Hoechst AG v. Commissioners of Inland Revenue & H.M. Attorney Gen., 2001 E.C.R. I-1727; *Gilly*, 1998 E.C.R. I-2793. The court in *Gilly* failed to give an answer to the question whether France, which under *Schumacker*, 1995 E.C.R. I-225, was required to allow the deduction of personal and family related expenses, was obliged to allow the deduction of the full amount of these expenses, or whether it could limit that deduction pro rata to the French source income portion of the total family income. See *Gilly*, 1998 E.C.R. I-2793. The ECJ subsequently ruled on this particular issue in favor of the taxpayer in *De Groot*, 2002 E.C.R. I-11819. The court in *Columbus Container* refused to determine whether Community law also should be read as a most favored nation obligation on the Member States. See *Columbus Container,* 2007 E.C.R. I-10451.

26 See Section II.C.

27 Community law does not apply to purely domestic situations in which there is no cross-border element. In *Werner* the ECJ decided that a frontier worker who resided in the Netherlands and worked in Germany was in a purely domestic situation because he had German nationality, German diplomas, and had never worked in the Netherlands. *Werner*, 1993 E.C.R. I-429, ¶¶ 16-17. But this decision was corrected in Case C-107/94, Asscher v. Staatssecretaris van Financiën, 1996 E.C.R. I-3089, ¶ 34, and *De Groot*, 2002 E.C.R. at I-11819, ¶¶ 76-80, in which the court held that Community law applies to a person working in one Member State and residing in another.

28 Generally the ECJ assumes that an activity has economic substance if it seeks to earn income or a profit. Case 66/85, Lawrie-Blum v. Land Baden-Württemberg, 1986 E.C.R. 2121, ¶ 20; Case 36/74, Walrave & Koch v. Ass'n Union Cycliste Internationale, 1974 E.C.R. 1405. In addition, in the case of an establishment there should be certain fixed premises from which a genuine economic activity is carried out. Case C-246/89, Commission v. United Kingdom, 1991 E.C.R. I-4585, ¶ 21.

29 Community law also guarantees nondiscrimination to natural persons who are Community citizens and who move around in the Community unrelated to any economic activity. Case C-520/04, Turpeinen, 2006 E.C.R. I-10685, ¶ 23; Case C-224/02, Pusa v. Osuuspankkien Keskinäinen Vakuatusyhtiö, 2004 E.C.R. I-5763, ¶¶ 16-18, 48.

yond a discrimination analysis.[30] In fact, it is a rather striking illustration of the court's self restraint in the income tax area that, in spite of the broad restriction-based reading of the Treaty that it applies in its overall internal market case law, the court in its income tax case law, semantics apart, always has focused on discrimination in the sense of denial of national treatment.[31]

This rather exclusive focus on discrimination in the sense of denial of national treatment has resulted, however, in a dogmatically questionable "dissimilarity-based" denial of an obligation on Member States to provide most favored nation (MFN) treatment and a refusal to assume an obligation of Member States to prevent unnecessary double burdens. Together, these two deviations from normal case law seem to have caused a kind of sovereignty exception for tax treaties. The different steps can be summarized as follows.

First, a most favored nation treatment obligation, which the court assumed applied in other areas of Community law,[32] was never accepted in the income tax area. In spite of hints in that direction in early income tax case law,[33] and strong theoretical arguments in favor of assuming such an obligation in an internal market,[34] the court ig-

[30] See Case C-403/03, Schempp v. Finanzamt München, 2005 E.C.R. I-6421 (indicating that the Treaty Freedoms do not remove disparities); see also Case C-513/04, Kerckhaert & Morres v. Belgium, 2006 E.C.R. I-10967.

[31] But see Case 293/06, Deutsche Shell GmbH v. Finanzamt für Großunternehmen in Hamburg, 2008 E.C.R._____, available at http://eur.lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:62006J0293:EN:HTML; Case C-250/95, Futura Participations SA & Singer v. Admin. des Contributions, 1997 E.C.R. I-2471.

[32] For most favored nation case law in the area of free movement of goods and persons, including social security, see Case C-55/2000, Gottardo v. Istituto Nazionale della Previdenza Sociale (INPS), 2002 E.C.R. I-413; Joined Cases C-367/93 to C-377/93, F.G. Roders BV v. Inspecteur der Invoerrechten en Accijnzen, 1995 E.C.R I-2229; C-235/87, Matteucci v. Communauté Française of Belgium, 1988 E.C.R. 5589.

[33] See Case C-307/97, Compagnie de Saint-Gobain, Zweigniederlassung Deutschland v. Finanzamt Aachen-Innenstadt, 1999 E.C.R. I-249 (holding benefits of tax treaties must be granted to permanent establishments of companies of other Member States); Case C-279/93, Finanzamt Köln-Altstadt v. Schumacker, 1995 E.C.R. I-225, ¶ 46 (referring to the German-Dutch frontier worker tax treaty); Case C-1/93, Halliburton Servs. BV v. Staatssecretaris van Financiën, 1994 E.C.R. I-1137 (referring to a Dutch Supreme Court decision resulting in transfer tax exemption in the case of a transfer of real estate from a U.S. parent to a Dutch subsidiary); Case 270/83, Commission v. France (*Avoir Fiscal*), 1986 E.C.R. 273 (holding imputation credit available to certain nonresidents on the basis of a tax treaty must be given to all nonresidents in a similar situation).

[34] In an internal market, differentiation between economic operators on the basis of their origin should not be allowed. The analogy with a domestic market, for instance France, is particularly convincing. After all, a trader or a worker from Marseille would be highly surprised if the product standards or working conditions applied to him in the Paris regional market were to differ from those that applied to his Bordeaux colleagues who are active in the Paris market. There is also an argument of pure logic. If Community law obliges a host Member State to grant national treatment to an incoming economic activity from one other home Member State, and to grant national treatment as well to an incoming economic activity from another home Member State, logically Community law obliges

nored the question for a long time,[35] before rejecting it on dubious "dissimilarity" grounds in *D. v. Inspecteur van de Belastingdienst*,[36] as regards host state, tax treaty-based, differentiation between incoming economic activity from different home Member States. Elsewhere I concluded that this line is unsustainable in the long run, because it essentially places tax treaties above the law.[37]

Second, the prohibition on double burdens is widely accepted in other areas of Community law,[38] including social security contributions[39] and value added tax (in particular in cases concerning trade in second-hand goods[40] and the temporary importation of cars[41]). But, although the court has recognized that the abolition of double taxa-

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Member States to grant the same treatment to the two incoming economic activities from the two home Member States. See Case 32/80, Criminal Proceedings Against J.A.W.M.J. Kortmann, 1981 E.C.R. 251.

35 See Joined Cases C-397/98 and C-410/98, Metallgesellschaft Ltd. & Hoechst AG v. Commissioners of Inland Revenue & H.M. Attorney Gen., 2001 E.C.R. I-1727; Case C-204/90, Bachmann v. Belgium, 1992 E.C.R. I-249.

36 Case C-376/03, D. v. Inspecteur van de Belastingdienst, 2005 E.C.R. I-5821. This position was confirmed in Case C-8/04, Bujura v. Inspecteur van de Belastingdienst Limburg, 2004 O.J. (C 59) 17, subsequently removed from register by Order of the President of the Fourth Chamber of the Court of Justice of the European Communities, 2006 O.J. (C 60) 32. For a critical analysis, see Servaas van Thiel, A Slip of the European Court in the *D* Case (C-376/03): Denial of the Most-Favoured-Nation Treatment Because of Absence of Similarity?, 33 Intertax 454 (2005).

37 See Servaas van Thiel, Why the ECJ Should Read Directly Applicable Community Law as an Obligation to Provide Most Favoured Nation Treatment, 47 Eur. Tax'n 263 (2007).

38 In the area of goods, see, e.g., Joined Cases C-267/91 and C-268/91, Criminal Proceedings against Keck & Mithouard, 1993 E.C.R. I-6097; Case 120/78, Rewe-Zentral AG v. Bundesmonopolverwaltung für Branntwein (*Cassis de Dijon*), 1979 E.C.R. 649; Case 8/74, Procureur du Roi v. Dassonville, 1974 E.C.R. 837. In the area of services, see, e.g., Case C-275/92, H.M. Customs & Excise v. Schindler, 1994 E.C.R. I-1039; Case C-76/90, Säger v. Dennemeyer & Co. Ltd., 1991 E.C.R. I-4221; Case C-198/89, Commission v. Greece, 1991 E.C.R. I-727; Case C-180/89, Commission v. Italy, 1991 E.C.R. I-709; Case C-154/89, Commission v. France, 1991 E.C.R. I-659; Case 205/84, Commission v. Germany, 1986 E.C.R. 3755. In the area of persons, see, e.g., Case C-415/93, Union Royale Belge des Sociétés de Football Association ASBL v. Bosman, 1995 E.C.R. I-4921; Case C-19/92, Kraus v. Land Baden-Württemberg, 1993 E.C.R. I-1663; Case C-104/91, Colegio Oficial de Agentes de la Propriedad Inmobiliaria v. Borrell, 1992 E.C.R. I-3003; Case C-340/89, Vlassopoulou v. Ministerium für Justiz, Bundes-und Europaangelegenheiten Baden-Württemberg, 1991 E.C.R. I-2357.

39 Case C-10/90, Masgio v. Bundesknappschaft, 1991 E.C.R. I-1119; Case 143/87, Stanton v. Institut National d'Assurances Sociales pour Travailleurs Indépendants (INASTI), 1988 ECR 3877; Joined Cases 154-155/87, Institut National d'Assurances Sociales pour Travailleurs Indepéndents (INASTI) v. Wolf et NV Microtherm Eur., 1988 E.C.R. 3897; Joined Cases 62-63/81, Société Anonyme de Droit Français Seco v. Etablissement d'Assurance Contre la Vieillesse et l'Invalidité, 1982 E.C.R. 223.

40 Case 50/88, Kühne v. Finanzamt München III, 1989 E.C.R. 1925; Case 165/88, ORO Amsterdam Beheer BV v. Inspecteur der Omzetbelasting Amsterdam, 1989 E.C.R. 4081; Case 39/85, G. Bergeeres—Becque v. Chef de Service Interrégional des Douanes, 1986 E.C.R. 259; Case 47/84, Staatssecretaris van Financiën v. Gaston Schul Douane-Expediteur BV, 1985 E.C.R. 1491; Case 16/84, Commission v. Netherlands, 1985 E.C.R. 2355; Case 17/

tion is a Community objective, it has denied the direct applicability of the relevant Treaty Article,[42] and thus far it has refused to read a prohibition of double taxation explicitly into the Treaty articles on the free movement of persons or capital.[43] Again I believe that this line is unsustainable in the long run. The main reason is that double taxation is widely recognized as one of the main tax obstacles to free movement and it is, after all, the Member States themselves that cause the problem of double taxation because, by taxing residents on worldwide income and nonresidents on domestic source income, they define their tax jurisdiction in an extra territorial way. In addition, the income tax case law is on this point inconsistent with case law in the other areas, and with more fundamental principles of Community law.[44]

Third, as a direct consequence of this artificial exclusive focus on national treatment, the case law shows a hybrid and partly ambiguous position of the ECJ towards tax treaties, that can be summarized as follows:

The court fully accepts (and can be expected to continue to accept) tax treaty-based conflict rules on the allocation of tax jurisdiction and the avoidance of double taxation, by which Member States shape their bilaterally agreed understanding of inter-jurisdictional equity.[45]

The court does not allow (and can be expected to continue to disallow), Member States to rely on the divergences between their "quid pro quo" tax treaties to extend substantive benefits, which are available to domestic situations, to certain, but not all, Community citizens in a similar situation, because this would lead to an internal market-incompatible distortion of taxpayer equity through discrimination and

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84, Commission v. Ireland, 1985 E.C.R. 2375; Case 15/81, Gaston Schul Douane Expediteur BV v. Inspecteur der Invoerrechten en Accijnzen, Roosendaal, 1982 E.C.R. 1409.

[41] In Case 249/84, Ministère Public v. Profant, 1985 E.C.R. 3237, ¶¶ 25-26, the ECJ held that Member States were required to apply the concept of temporary importation in such a way as to avoid derogating, by taxing their vehicles twice, the freedom of nationals of Member States to pursue their studies in the Member State of their choice. See also Council Directive 83/182, On Tax Exemptions Within the Community for Certain Means of Transport Temporarily Imported, 1983 O.J. (L 105) 59.

[42] EC Treaty, note 4, art. 293; see Case C-336/96, Gilly v. Directeur des Services Fiscaux du Bas-Rhin, 1998 E.C.R. I-2793.

[43] Case C-513/04, Kerckhaert & Morres v. Belgium, 2006 E.C.R. I-10967.

[44] See Servaas van Thiel, Income Tax Payments and Social Security Contributions from a Community Law Point of View: How the European Court of Justice Could Streamline Its Approach in the Interest of the Internal Market, in 43 Double Tax Conventions and Social Security Conventions 37 (Michael Lang ed., 2005); see also 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, note 21, at 331 [hereinafter The Future].

[45] Case C-307/97, Compagnie de Saint-Gobain, Zweigniederlassung Deutschland v. Finanzamt Aachen-Innenstadt, 1999 E.C.R. I-6161; *Gilly*, 1998 E.C.R. I-2793.

it would make the application of Community law subject to a condition of reciprocity.[46]

In a recent line of cases,[47] however, the ECJ has started to accept all tax treaty clauses, whether containing conflict rules or providing substantive tax benefits for taxpayers, on the ground that the strictly bilateral nature of tax treaties would cause dissimilarity between taxpayers covered by different treaties.[48] It thus created a sort of "above the law" status for tax treaties.

The exclusive focus of the ECJ on national treatment in the direct tax area, and hence the recent line of case law on tax treaties, is unsustainable in the long run. First, this recent case law line on tax treaties allows two Member States together to discriminate between internal market participants, by bilaterally agreeing to variable tax burdens on cross-border economic activity on the basis of origin.[49] Second, the court confuses the right of Member States to shape the balance in rights and obligations as regards the allocation of jurisdiction and the avoidance of double taxation (a revenue balance between Member States shaping inter-jurisdictional equity),[50] with the prohibition on using tax treaties to vary the substantive rights and duties of taxpayers (causing different tax burdens for similar tax payers in the internal market and thus distorting taxpayer equity).[51] In the *D* case the ECJ incorrectly assumed that the quid pro quo balance in tax treaties,

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[46] *Saint-Gobain*, 1999 E.C.R. I-6161; Case 270/83, Commission v. France (*Avoir Fiscal*), 1986 E.C.R. 273.

[47] Case C-376/03, D. v. Inspecteur van de Belastingdienst, 2005 E.C.R. I-5821 (accepting different tax treatment by the host state, the Netherlands, of the same incoming economic activity from Belgium and Germany, respectively); Case C-446/04, Test Claimants in the FII Group Litig. v. Commissioners of Inland Revenue, 2006 E.C.R. I-11753 (leaving Member States to have the choice to exempt domestic dividends from tax (under national tax law), while applying an imputation credit to inbound dividends (under tax treaties) thus ignoring the resulting cash flow discrimination, because the "additional administrative burdens on taxpayers" are "an intrinsic part of the operation of a tax credit system" and "cannot be regarded as a difference in treatment which is contrary to freedom of establishment."); Case C-374/04, Test Claimants in Class IV of the ACT Group Litig. v. Commissioners of Inland Revenue, 2006 E.C.R. I-11673 (limitation-of-benefit clauses contained in a tax treaty are acceptable, essentially because they contribute to the reciprocal balance of rights and duties, and are an inherent consequence of bilateral double taxation conventions).

[48] *D.*, 2005 E.C.R. I-5821; *FII Group Litig.*, 2006 E.C.R. I-11753; *ACT Group Litig.*, 2006 E.C.R. I-11673.

[49] The direct outcome of the *D.* decision is that the Netherlands and Belgium are now allowed bilaterally to agree to discriminate against third Member State operators (higher tax burden) by favoring each other's economic operators (lower tax burden) over the economic operators from all other Member States (denial of most favored nation treatment). *D.*, 2005 E.C.R. I-5821.

[50] *Gilly*, 1998 E.C.R. I-2793.

[51] *Avoir Fiscal*, 1986 E.C.R. 273; *Saint-Gobain*, 1999 E.C.R. I-6161; Case C-385/00, De Groot v. Staatssecretaris van Financiën, 2002 E.C.R. I-11819.

which it had to respect, was made up not only of allocation rules that distribute revenue between tax jurisdictions (ensuring inter-jurisdictional equity), but also of tax treaty rules that concern private sector tax obligations and may thus result in a different tax burden for taxpayers (distorting taxpayer equity).[52] Third, it will be difficult to reserve this "above the law status," based on an assumed reciprocal balance of rights and obligations, exclusively to bilateral tax treaties, for the simple fact that all bilateral treaties are based on an assumed balance of rights and duties; otherwise the contracting parties would not have agreed to sign and conclude those treaties. Interestingly in the case of nontax treaties the ECJ takes the opposite approach.[53] A fourth problem is that such an "above the law" status of tax treaties does not fit well with the constitutional principles of direct effect[54] and the primacy[55] of Community law.

I therefore would expect the court, sooner or later, to abandon the sovereignty exception for tax treaties and return to the more traditional understanding that Member States may freely conclude tax treaties and decide on the criteria for allocating tax jurisdiction, but that tax treaties neither can give rise to nor justify an EC-incompatible

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[52] See *D.*, 2005 E.C.R. I-5821.

[53] In the "Open Skies" cases the court took a totally different approach. Case C-466/98, Commission v. United Kingdom, 2002 E.C.R. I-9427; Case C467/98, Commission v. Denmark, 2002 E.C.R. I-9519; Case C-468/98, Commission v. Sweden, 2002 E.C.R. I-9575; Case C-469/98, Commission v. Finland, 2002 E.C.R. I-9627; Case C-471/98, Commission v. Belgium, 2002 E.C.R. I-9681; Case C-472/98, Commission v. Luxembourg, 2002 E.C.R. I-9741; Case C-475/98, Commission v. Austria, 2002 E.C.R. I-9797; Case C-476/98, Commission v. German, 2002 E.C.R. I-9855 (collectively, hereinafter Open Skies).

[54] In its landmark decision in Case 26/62, NV Algemene Transport en Expeditie Onderneming van Gend & Loos v. Netherlands Inland Revenue Admin., 1963 E.C.R. 1, the ECJ noted that the Treaty is more than an agreement that merely creates mutual obligations between the contracting states, as confirmed, inter alia, by the fact that it refers not only to governments but also to peoples and by the establishment of institutions endowed with sovereign rights, the exercise of which affects governments and citizens. It concludes that "the Community constitutes a new legal order of international law for the benefit of which the states have limited their sovereign rights, albeit within limited fields, and the subjects of which comprise not only Member States but also their nationals." Id. The ECJ subsequently decided that these citizens can invoke their Community law rights before national courts. See Case 50/76, Amsterdam Bulb BV v. Produktschap voor Siergewassen, 1977 E.C.R. 137; Case 34/73, Fratelli Variola S.p.A. v. Amministrazione italiana delle Finanze, 1973 E.C.R. 981; Case 43/71, Politi s.a.s. v. Ministry for Finance, 1971 E.C.R. 1039; Case 6/64, Costa v. Ente Nazionale per l'Energia Elettrica (ENEL), 1964 E.C.R. 585.

[55] See Case C-213/89, The Queen v. Sec'y of State for Transp., ex parte Factortame Ltd, 1990 E.C.R. I-2433, ¶ 18; Case 106/77, Amministrazione delle Finanze dello Stato v. Simmenthal SpA, 1978 E.C.R. 629, ¶ 17; *Politi*, 1971 E.C.R. 1039, ¶ 9; Case 11/70, Internationale Handelsgesellschaft mbH v. Einfuhr- und Vorratsstelle für Getreide und Futtermittel, 1970 E.C.R. 1145, ¶ 3; Case 14/68, Wilhelm v. Bundeskartellamt, 1969 E.C.R. 1, ¶ 6; Case 9/65, Acciaierie San Michele SpA v. High Auth. of the European Coal & Steel Cmty., 1967 E.C.R. 1; *ENEL*, 1964 E.C.R. at 593-94. For an early confirmation of supremacy in the income tax area, see Case 6/60, Humblet v. Belgium, 1960 E.C.R. 559.

discrimination. This would mean, first, that substantive tax benefits that are foreseen for residents by the tax system of one of the contracting Member States no longer can be granted or denied on the basis of reciprocity, but, on the basis of Community law, must be either abolished or extended to all nonresident taxpayers in a similar position as resident taxpayers. This also would mean that the court will have to clarify the difference between substantive tax treaty and conflict rules. Although this may not always be an easy task, it is quite clear to many tax lawyers that the bulk of tax treaties remain in the safe area because they allocate tax jurisdiction. Safe allocation rules most likely would include the agreed combined application by the source state of withholding taxes and by the residence state of a credit to avoid double taxation as recommended by the OECD Model Convention,[56] because the essential effect of these rules is to share revenue between tax jurisdictions rather than to differentiate the tax burden of the cross-border and the domestic taxpayers. The court already has recognized this indirectly.[57]

C. *European Taxpayers Have Broad Access to Community Law, But What About Third Country Corporate Groups?*

The Treaty articles on the free movement of workers,[58] the freedom of establishment,[59] and the free movement of services[60] apply, in principle, to any qualifying person engaged in an intra-Community cross-border activity.[61] The Treaty provisions on the free movement of cap-

[56] OECD, Model Tax Convention on Income and on Capital, July 15, 2005, arts. 10-12, 23, 1 Tax Treaties (CCH) ¶ 210.23, available at http://oecd.org/dataoecd/50/49/35363840.pdf [hereinafter OECD Model Treaty].

[57] In Case C-170/05, Denkavit Internationaal BV v. Ministre de l'Économie, des Finances et de l'Industrie, 2006 E.C.R. I-11949, the court held that France's different treatment of domestic dividends (no withholding tax and exempt in the hands of the shareholder) and outbound dividends (subject to a French withholding tax and exempt from tax in the hands of the Dutch shareholder) constituted discrimination, and that the discriminatory effect of the French withholding tax was not eliminated by a foreign tax credit on the Dutch side. Contrary to what the tax treaty provided, the Netherlands did not credit the French withholding tax but exempted the dividends received from income tax. See id. ¶ 56.

Case C-379/05, Amurta SGPS v. Inspecteur van de Belastingdienst/Amsterdam, 2007 E.C.R. I-9569. The court found that a tax treaty could neutralize the restrictive effect of a tax measure applied by one of the contracting states to the treaty. Id. ¶ 84. The court, however, left the ultimate question of the treaty's neutralizing effect for the national court of such contracting state to determine. Id.

[58] EC Treaty, note 4, arts. 39-42.

[59] Id. arts. 43-48.

[60] Id. arts. 49-55.

[61] Community law does not apply to purely domestic situations in which there is no cross-border element. See Case C-112/91, Werner v. Finanzamt Aachen-Innenstadt, 1993 E.C.R. I-429.

ital[62] apply irrespective of the quality of the persons involved, like those on the free movement of goods,[63] and, in addition, they apply intra-Community and from and to third countries.

According to standard case law, qualifying persons include all Community citizens (nationality requirement) and all profit-seeking Community companies (seat requirement).[64] In addition, certain third-country nationals can invoke Community law if they have a special relation to a Community person who exercises his right to free movement.[65] Other third-country nationals, in principle, have no access to Community law, not even if they are legally active in one of the Member States,[66] unless they are covered by certain international agreements that extend EC Treaty benefits to third-country situations and/or third-country nationals and companies.[67]

Intra-Community situations include all those between Member States, as well as third-country situations covered by a treaty. Third-country situations involving third-country nationals or companies not

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62 EC Treaty, note 4, arts. 56-60.

63 Id. arts. 23-38.

64 See, e.g., Case 238/83, Caisse d'Allocations Familiales de la Region Parisienne v. Meade, 1984 E.C.R. 2631 (holding that the Treaty Article on natural persons only applied to workers of the Member States). Article 48 provides:

> Companies or firms formed in accordance with the law of a Member State and having their registered office, central administration or principal place of business within the Community shall . . . be treated in the same way as natural persons who are nationals of Member States.
>
> 'Companies or firms' means companies or firms constituted under civil or commercial law, including cooperative societies, and other legal persons governed by public or private law, save for those which are non-profit-making.

EC Treaty, note 4, art. 48. In Case C-330/91, The Queen v. Inland Revenue Commissioners, ex parte Commerzbank AG, 1993 E.C.R. I-4017, the ECJ clarified that companies qualify for Treaty benefits if they have their seat, in the sense of Article 48, in the Community.

65 Natural persons with third-country nationality may enjoy derived Community rights as dependent members of the family of migrating Community nationals or as employees of Community citizens who exercise their freedom to provide services. See, e.g., Case 131/85, Gül v. Regierungspräsident Düsseldorf, 1986 E.C.R. 1573 (allowing a Cypriot doctor access to the medical profession in Germany because he was the spouse of a UK national who had moved to Germany to work as a hairdresser); Joined Cases 62-63/81, Société Anonyme de Droit Français Seco v. Etablissement d'Assurance Contre la Vieillesse et l'Invalidité, 1982 E.C.R. 223 (holding that a Member State's power to control the employment of third-country nationals may not be used to impose a discriminatory burden on an undertaking from another Member State enjoying the freedom to provide services); see also Case C-113/89, Rush Portuguesa LDA v. Office National d'Immigration, 1990 E.C.R. I-1417 (deciding that a Member State could not prohibit a provider of services from freely travelling with its entire staff).

66 Case C-290/04, FKP Scorpio Konzertproduktionen GmbH v. Finanzamt Hamburg-Eimsbüttel, 2006 E.C.R. I-9461, ¶¶ 68-69.

67 See, e.g., Agreement on the European Economic Area, pt. III, May 2, 1992, 1994 O.J. (L 1) 3; Bilateral Agreement on the Free Movement of Persons, EU-Switz., art. 1, June 21, 1999, 2002 O.J. (L 114) 6.

covered by the free movement of capital provisions nor by a special treaty, fall outside the scope of application of the Treaty.

Since 2005, when the ECJ became more prudent, there have been cases that the court considered to be outside the scope of the Treaty freedoms, either because those seeking access to Community law did not qualify under the Treaty,[68] or because the cases concerned did not qualify as intra-Community situations.[69] Likewise the court can be expected to deny access to a non-EU multinational company that itself seeks direct access from a third country to the internal market. This tallies well with the fact the Doha Round of multinational trade negotiations partly concerns the extent to which WTO Members are willing, in their GATS schedules of commitments, to grant each others' service providers market access either by allowing the supply of such services directly from abroad to domestic clients (cross border supply), by allowing the indirect supply of such services to domestic clients through local branches or subsidiaries (cross-border establishment), or through temporarily incoming natural persons (movement of natural persons).[70]

In a more dubious recent line of income tax case law, however, the ECJ decided to deny EC Treaty benefits to third-country corporate groups, not only by denying a foreign company direct access from the third country to the internal market,[71] but also by qualifying an intra-Community, intra-group transaction between two EU companies (both subsidiaries) as an establishment by their common parent from a third country into the EU (inward) or from the EU into a third country (outward) (to which Community law on the free movement of persons does not apply), rather than as an intra- or extra-Community capital movement (to which Community law on the free movement of

[68] *Scorpio*, 2006 E.C.R. I-9461, ¶ 68. A third-country national, even if legally (self-) employed in one of the Member States, does not have access to EC Treaty rights to free movement to provide services. Id.

[69] Case C-415/06, Stahlwerk Ergste Westig GmbH v. Finanzamt Düsseldorf-Mettmann, 2007 E.C.R. I-151 (2008) (holding that Community law does not apply to an outward investment by a German company in the form of a U.S. branch); Case C-102/05, Skatteverket v. A and B, 2007 E.C.R. 3871 (ruling that Sweden may ignore workers employed by a Russian subsidiary of a closely held Swedish company, while taking account of workers employed by European Economic Area (EEA) subsidiaries, when determining the ceiling amount of profits that the Swedish company could distribute to its shareholders/ workers as low-taxed dividends (rather than as higher taxed employment income). The Swedish rule applies to situations involving control, to which establishment rules apply, which, however, do not apply to outward establishment into Russia).

[70] General Agreement on Trade in Services, Apr. 15, 1994, Marrakesh Agreement Establishing the World Trade Organization, Annex 1B, Results of the Uruguay Round, 33 I.L.M. 1125, 1168 (1994), available at http://www.wto.org/English/docs_e/legal_e/26-gats.pdf.

[71] See Case C-452/04, Fidium Finanz AG v. Bundesanstalt Für Finanzdienstleistungsaufsicht, 2006 E.C.R. I-9521.

capital does apply).[72] To put it more crudely, the fact that EU companies are controlled by non-EU parents may well exclude them from the benefits of the Treaty, because their common parent would not have access to the Treaty.

This more recent line is unsustainable. First, it is at odds with the Treaty provisions on establishment[73] and the illustrative list of capital movements in the Annex to Directive 88/361,[74] to qualify a loan between two separate Community companies not as an intra-Community capital movement but as an extra-Community inward establishment, merely because it is effected between related companies under common control. Second, it is questionable to consider the intra-Community loan not as an establishment by the provider of the loan into the Member State of the borrower, but rather as an establishment by their common U.S. parent into the Community. Third, the rather painful contradiction arises that an intra-Community loan between two Community companies is declared outside the scope of the application of directly applicable Community law (because they both form part of a multinational with its headquarters outside Europe), whereas loans from and to third-country companies in principle would be covered by the Treaty provisions on capital[75] if between unrelated companies. Fourth, extending the reasoning a little bit further into the area of free movement of goods could have the ad absurdum result that Member States would be allowed to apply customs duties or quantitative restrictions on the intra-Community supply of goods between two EU companies of different Member States if both are wholly-owned subsidiaries of a non-EU parent, because in that case someone might believe that the intra-Community transaction does not constitute an intra-Community supply of goods, but rather an inward establishment by the non-European parent (to which the Treaty articles on establishment do not apply). Fifth, the decision raises a question about several previous decisions of the ECJ concerning large multinational companies with their headquarters outside Europe.[76] Sixth, the decision makes it unclear what to do if that third country multinational company sets up a holding company in any EU Member State and manages its European activities through that European

[72] Case C-524/04, Test Claimants in the Thin Cap Group Litig. v. Commissioners of Inland Revenue, 2007 E.C.R. I-2107 (holding an intra-Community loan between companies of two Member States is qualified as inward establishment into the Community by their common U.S. parent to which the Treaty does not apply).

[73] EC Treaty, note 4, arts. 43-48.

[74] Council Directive 88/361, Annex I, 1988 O.J. (L 178) 5, 8.

[75] EC Treaty, note 4, arts. 56-60.

[76] See, e.g., Case C-1/93, Halliburton Services BV v. Staatssecretaris van Financiën, 1994 E.C.R. I-1137.

holding company. Assuming that the holding company undertakes real economic activities, the question arises whether it will be allowed access to the Treaty benefits (because it is a qualifying person engaged in an intra-Community cross-border economic activity) or not (because the intra-Community activities of the European company are attributed to the third country company, which is not a qualifying person for the purpose of Community law).

I therefore would respectfully submit that the court in due time should return to its more traditional line in *Halliburton* in which it applied Community law to an intra-Community transaction between qualifying legal persons, even though these were under common control of a U.S. parent.[77]

III. Prohibited Discriminatory Tax Measures

A. *Prohibited Exit Taxes Imposed by the Home Member State*

Although the ECJ has been reluctant to address the EC compatibility of exit taxes imposed by the home state in its early income tax case law,[78] the breakthrough came with *Imperial Chemical Industries plc (ICI) v. Colmer*[79] and this opened a flood of cases on prohibited exit taxes. From this case law the rule of thumb can be deduced that any tax measure that causes a higher tax burden for a person who leaves a tax jurisdiction, as compared to the person who stays at home, constitutes an EC-incompatible exit restriction.

Prohibited exit taxes include exit taxes on (unrealized) capital gains, that is, any measure according to which (realized or unrealized) capital gains are taxed only when a taxpayer or an asset leaves the home state jurisdiction and not when the taxpayers or assets remain at home.[80] The four subcategories of (unrealized) capital gains that have been the subject of decisions by the ECJ include capital gains that are locked into the value of corporate assets of a company that seeks to

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[77] In *Halliburton* the court considered the transfer of a Dutch branch by a German subsidiary of a U.S. multinational to a Dutch subsidiary of that same multinational, as an intra-Community cross-border activity by a qualifying person. Id. ¶¶ 3-4, 23.

[78] Case C-112/91, Werner v. Finanzamt Aachen-Innenstadt, 1993 E.C.R. I-429. In *Werner* the court could have considered that the contested German measure constituted an exit restriction and would dissuade German workers from taking up residence in another Member State. Case C-175/88, Biehl v. Administration des contributions du grand-duché de Luxembourg, 1990 E.C.R. I-1779; Case 81/87, The Queen v. H.M. Treasury, ex parte Daily Mail, 1988 E.C.R. 5483.

[79] Case C-264/96, Imperial Chem. Indus. plc v. Colmer, 1998 E.C.R. I- 4695, ¶ 30 (holding companies have the right of exit and the U.K. rule in question, under which a group of companies would lose the benefit of loss compensation between U.K. group members if the majority of the group members were established outside the United Kingdom, constituted an EC-incompatible exit restriction).

[80] See notes 81-84.

exit its home jurisdiction,[81] unrealized capital gains locked into the value of shares whereby the direct or indirect ownership of the shares moves out of the jurisdiction,[82] capital gains on immovable property,[83] and capital gains that are accumulated in a pension reserve.[84]

Prohibited exit taxes also include tax exemptions that are reserved for domestic source income items and do not apply to similar foreign source income items,[85] as well as tax deductions for expenses incurred at home but not for similar expenses incurred abroad.[86]

In a separate line of cases the court was more prudent with respect to cross-border losses, or rather the extent to which consolidation between domestic members of the same group should be available also to members located in other Member States.[87] In these cases the ECJ weighed the prohibition on discrimination against other considerations, including: (1) the general understanding between Member States that both profits and losses of foreign subsidiaries in principle should be taken into account by the state in which the subsidiary is located, (2) the need to prohibit groups of companies from shifting

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[81] *Daily Mail*, 1988 E.C.R. 5483; see also Case C-210/06, Cartesio Oktató És Szolgáltato-Betéti Társaság, 2008 E.C.R. ___ (Opinion of Advocate General Maduro), available at http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:62006C0210:EN:HTML.

[82] Case C-470/04, N v. Inspecteur van de Belastingdienst Oost/kantoor Almelo, 2006 E.C.R. I-7409; Case C-268/03, De Baeck v. Belgium, 2004 E.C.R. I-5961; Case C-9/02, de Lasteyrie du Sailant v. Ministère de l'Économie, des Finances et de l'Industrie, 2004 E.C.R. I-2409; Case C-436/00, X and Y v. Riksskatteverket, 2002 E.C.R. I-10829.

[83] Case C-104/06, Commission v. Sweden, 2007 E.C.R. I-671; Case C-345/05, Commission v. Portugal, 2006 E.C.R. I-10633.

[84] Case C-522/04, Commission v. Belgium, 2007 E.C.R. I-5701.

[85] Case C-464/05, Geurts v. Administratie van de BTW, Registratie en Domeinen, 2007 E.C.R. I-9325; Case C-251/98, Baars v. Inspecteur der Belastingen Particulieren/Ondernemingen Gorinchem, 2000 E.C.R. I-2787; Case C-35/1998, Staatssecretaris van Financiën v. Verkooijen, 2000 E.C.R. I-4071.

[86] Case C-318/05, Commission v. Germany, 2007 E.C.R. I-6957 (cross-border research and training costs); Case C-76/05, Schwarz v. Finanzamt Bergisch Gladbach, 2007 E.C.R. I-6849; *Belgium*, 2007 E.C.R. 5701 (cross-border insurance premiums); Case C-471/04, Finanzamt Offenbach am Main-Land v. Keller Holding GmbH, 2006 E.C.R. I-2107 (cross-border dividends); Case C-150/04, Commission v. Denmark, 2007 E.C.R. I-1163 (cross-border pension funds); Case C-39/04, Laboratoires Fournier SA v. Direction des Vérifications Nationales et Internationales, 2005 E.C.R. I-2057 (cross-border research tax credits); Case C-422/01, Försäkringsaktiebolaget Skandia v. Riksskatteverket, 2003 E.C.R. I-6817 (cross-border insurance policies); Case C-168/01, Bosal Holding BV v. Staatssecretaris van Finaciën, 2003 E.C.R. I-9409 (cross-border dividends); Case C-324/00, Lankhorst-Hohorst GmbH v. Finanzamt Steinfurt, 2002 E.C.R. I-11779 (cross-border financing costs); Case C-136/00, Danner, 2002 E.C.R. I-8147 (cross border pension insurance); Case C-55/98, Skatterministeriet v. Vestergaard, 1999 E.C.R. I-7641 (cross-border professional training courses); Case C-294/97, Eurowings Luftverkehrs AG v. Finanzamt Dortmund-Unna, 1999 E.C.R. I-7447 (cross-border leasing costs); Case C-254/97, Société Baxter v. Premier Minstre, 1999 E.C.R. I-4809 (cross-border research expenditures); Case C-204/90, Bachmann v. Belgium, 1992 E.C.R. I-249 (cross-border insurance premiums).

[87] See Case C-231/05, Oy AA, 2007 E.C.R. I-6373; Case C-446/03, Marks & Spencer plc v. Halsey, 2005 E.C.R. I-10837.

profits to such an extent that group losses are concentrated in high-tax jurisdictions and group profits in low-tax jurisdictions, and (3) the need to avoid a double dip whereby companies would be able to deduct losses twice (that is, in the state of the subsidiary and in the state of the parent).[88] The ECJ thus decided that a domestic loss compensation scheme did not have to be extended automatically to group members in other Member States (as this carried the risk of tax avoidance and double dip that could erode the right of the residence state to tax domestic source income), but that final (liquidation) losses of foreign subsidiaries (that can neither be taken into account abroad nor shifted) should be transferable to the parent if this could be done in a domestic context.[89]

Prohibited exit taxes also include measures that impose a higher tax rate on cross-border income than on domestic income, whether by means of a rate option,[90] or withholding taxes.[91]

From this case law the conclusion can be drawn that the ECJ can be expected to continue to interpret directly applicable Community law as a broad prohibition of exit taxes, that is, as a prohibition of any higher burden imposed by the home Member State on taxpayers who (want to) leave the tax jurisdiction, compared to persons in a similar situation who stay within the tax jurisdiction. Any higher tax burden that could dissuade persons from exercising their right of free movement is prohibited, irrespective of whether the higher tax burden or dissuading effect results from the setup of the tax system (classical system or measures to avoid economic double taxation of dividends),

[88] See, e.g., *Oy AA*, 2007 E.C.R. I-6373, ¶¶ 44-60; *Marks & Spencer*, 2005 E.C.R. I-10837, ¶¶ 42-51.

[89] See *Marks & Spencer*, 2005 E.C.R. I-10837, ¶¶ 42-51.

[90] See Case C-315/02, Lenz v. Finanzlandesdirektion für Tirol, 2004 E.C.R. I-7063, ¶ 49; Case C-334/02, Commission v. France, 2004 E.C.R. I-2229, ¶ 34.

[91] See, e.g., Case C-170/05, Denkavit Internationaal BV v. Ministre de l'Économie, des Finances et de l'Industrie, 2006 E.C.R. I-11949; Case C-520/04, Turpeinen, 2006 E.C.R. I-10685; Case C-290/04, FKP Scorpio Konzertproduktionen GmbH v. Finanzamt Hamburg-Eimsbüttel, 2006 E.C.R. I-9461. In *Scorpio*, the court held that the withholding tax imposed by Germany on domestic source income earned by nonresident artists constitutes an access restriction to the German market and also an exit restriction for the enterprise that organized the artistic events in Germany. Id. ¶ 49. In *Turpeinen*, the court held that a switch from a net assessment and a progressive tax to a 35% withholding tax on Finnish source pension income paid to a Finn who emigrated to Spain amounted to a discriminatory exit restriction because the pension attracted a higher Finnish tax burden than the one that had applied had the Finn stayed at home. *Turpeinen*, 2006 E.C.R. I-10685, ¶ 39. In *Denkavit*, a French withholding tax on outbound dividends received by a Dutch shareholder who was exempt from further income tax on the dividends received constituted a discriminatory exit restriction where a similar domestic dividend was not subject to a withholding tax (while the resident shareholder was also almost entirely exempt from further tax on the dividends received) and taking account of the fact that the discriminatory effect of the French withholding tax was not eliminated by a foreign tax credit in the Netherlands (as foreseen in the double tax treaty). *Denkavit*, 2006 E.C.R. I-11949, ¶ 41.

the definition of the tax base (gross income, exemptions, deductions), tax rates, tax credits, or even procedural rules. As regards cross-border loss compensation, however, the court is more prudent.

B. *Prohibited Access Taxes Imposed by the Host Member State*

The ECJ has applied the prohibition on discriminatory access restrictions, which it had developed in its general internal market case law (overt and covert discrimination), from the outset in its income tax case law, in particular as regards foreign-owned permanent establishments and subsidiaries, as well as incoming frontier or migrant workers.[92]

It is settled case law that foreign-owned domestic permanent establishments are entitled to the same tax benefits as domestic enterprises (because taxed in the same way), including domestically available imputation credits,[93] interest payments in the case of late refund of overpaid tax,[94] participation exemptions and credits irrespective of whether available under national law or tax treaties,[95] reduced corporate income tax rates on certain types of income,[96] and lower split rates of corporate income tax to avoid economic double taxation of dividends.[97]

It is also settled case law that foreign-owned domestic subsidiaries are entitled to the same tax benefits as domestic-owned domestic subsidiaries (and cannot be discriminated against on the basis that the parent has its seat in another Member State), including as regards the deduction of R&D costs,[98] an exemption from advance payment of corporate tax,[99] the deductibility of interest,[100] and the exemption

92 See Case C-175/88, Biehl v. Admin. des Contributions du Grand-Duché de Luxembourg, 1990 E.C.R. I-1779; Case C-270/83, Commission v. France (*Avoir Fiscal*), 1986 E.C.R. 273.

93 *Avoir Fiscal*, 1986 E.C.R. 273.

94 Case C-330/91, The Queen v. Inland Revenue Commissioners, ex parte Commerzbank AG, 1993 E.C.R. I-4017.

95 Case C-307/97, Compagnie de Saint-Gobain, Zweigniederlassung Deutschland v. Finanzamt Aachen-Innenstadt, 1999 E.C.R. I-6161.

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

97 Case C-253/03, CLT-UFA SA v. Finanzamt Köln-West, 2006 E.C.R. I-1831. Though at first glance a surprising decision because economic double taxation of dividends does not occur in head office-branch situations, it becomes more understandable in cases in which Germany does not impose a withholding tax on the outbound dividends and Luxembourg exempts dividends received by corporate shareholders (so that no economic double taxation of dividends occurs either).

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

99 Joined Cases C-397/98 and C-410/98, Metallgesellschaft Ltd. & Hoechst AG v. Commissioners of Inland Revenue & H.M. Attorney Gen., 2001 E.C.R. I-1727.

100 Case C-324/00, Lankhorst-Hohorst GmbH v. Finanzamt Steinfurt, 2002 E.C.R. I-11779.

from a withholding tax unless matched by a tax credit in the other state.[101]

It is moreover settled case law that frontier workers, professionals, or natural persons who work in more than one Member State are considered to be in a comparable situation as their domestic host state colleagues, and thus are entitled under Community law to deduct personal and family expenses in the work state, if they earn all their income in the host Member State (so that they cannot deduct any expenses in their residence state).[102] The underlying reason for this prima facie complicated similarity test is to strike a balance between the need to uphold the nondiscrimination principle in the interest of the internal market (if a Member State allows deductions to a domestic worker, it must allow the same deductions to the incoming frontier worker) and the need to prevent cross-border workers from enjoying an undue advantage (if they earn income in two states they should not be able to deduct the expenses in the work state on the basis of Community law and in the residence state on the basis of international tax law). Interestingly, when it comes to the deduction of business expenses, the ECJ has ruled that irrespective of the place where the income is earned, any costs directly related to the income-earning activity should be deductible in the work state.[103]

In conclusion, unlike international tax law, EC law generally requires Member States, in principle, to grant foreign-owned branches and/or subsidiaries, incoming cross-border workers, and self-employed persons all the tax advantages granted to domestic enterprises, workers, or self-employed professionals, to the extent they are in a similar situation.[104] Again, as in the case of prohibited exit taxes, it is irrelevant whether the higher tax burden or dissuading effect on the

[101] Case C-379/05, Amurta SGPS v. Inspecteur van de Belastingdienst/Amsterdam, 2007 E.C.R. I-9569; Case C-170/05, Denkavit Internationaal BV v. Ministre de l'Économie, des Finances et de l'Industrie, 2006 E.C.R. I-11949; Case C-374/04, Test Claimants in Class IV of the ACT Group Litig. v. Commissioners of Inland Revenue, 2006 E.C.R. I-11673; Case C-446/04, Test Claimants in the FII Group Litig. v. Commissioners of Inland Revenue, 2006 E.C.R. I-11753; Case E-1/04, Fokus Bank ASA v. Norway, 1 C.M.L.R. 10 (Eur. Free Trade Area Ct. 2005).

[102] Case C-169/03, Wallentin v. Riksskatteverket, 2004 E.C.R. I-6443; Case C-385/00, De Groot v. Staatssecretaris van Financiën, 2002 E.C.R. 11819; Case C-87/99, Zurstrassen v. Admin. des Contributions Directes, 2000 E.C.R. I-3337; Case C-391/97, Gschwind v. Finanzamt Aachen-Außenstadt, 1997 E.C.R. I-5451; Case C-336/96, Gilly v. Directeur des Services Fiscaux du Bas-Rhin, 1998 E.C.R. I-2793; Case C-107/94, Asscher v. Staatssecretaris van Financiën, 1996 E.C.R. I-3089; Case C-80/94, Wielockx v. Inspecteur der Directe Belastingen, 1995 E.C.R. I-2493; Case C-279/93, Finanzamt Köln-Altstadt v. Schumacker, 1995 E.C.R. I-225; Case C-112/91, Werner v. Finanzamt Aachen-Innenstadt, 1993 E.C.R. I-429.

[103] Case C-346/04, Conijn v. Finanzamt Hamburg-Nord, 2006 E.C.R. I-6137; Case C-234/01, Gerritse v. Finanzamt Neukölln-Nord, 2003 E.C.R. I-5933.

[104] See, e.g., *Wallentin*, 2004 E.C.R. I-6443, ¶ 24.

incoming economic activity results from rules of the tax system or from the avoidance of economic double taxation,[105] the tax base,[106] tax rates,[107] or tax credits.[108]

The ECJ can be expected to continue to interpret directly applicable Community law as a broad prohibition of discriminatory access taxes, that is, as a prohibition of any higher burden imposed by the host Member State on taxpayers who (want to) access the tax jurisdiction, compared to those in a similar domestic situation. Any higher tax burden that could dissuade access constitutes a prohibited income tax discrimination by the host Member State irrespective of whether it results from the setup of the tax system (classical system or measures to avoid economic double taxation of dividends), the definition of the tax base (gross income, exemptions, deductions), tax rates, tax credits, or even procedural rules.

C. *The Avoidance of Economic and Juridical Double Taxation of Dividends: A Combination of Exit and Access Restrictions*

An interesting illustration of the fact that the ECJ will apply its well-established internal market principles in the income tax area, even though this may lead to results that are breathtaking in international tax law, is the range of cases concerning economic and juridical double taxation of dividends. In view of the fact that this issue is extensively discussed by Hellerstein, Kofler, and Mason in their excellent article,[109] I limit myself here to some general remarks.

When a Member State decides to avoid economic double taxation of dividends (that is, decides not to apply the classical system of income taxation), the ECJ has clearly taken the line that it must provide domestic shareholders with the same benefits on inbound dividends as those available on domestic dividends whether the mitigation method is a participation exemption,[110] an imputation credit,[111] or a reduced

[105] See Section III.C.

[106] See, for example, the cases cited in note 102.

[107] See, e.g., Case C-253/03, CLT-UFA SA v. Finanzamt Köln-West, 2006 E.C.R. I-1831; Case C-315/02, Lenz v. Finanzlandesdirektion für Tirol, 2004 E.C.R. I-7063; Case C-311/97, Royal Bank of Scotland plc v. Greece, 1999 E.C.R. I-2651.

[108] See text accompanying notes 114-16.

[109] See Walter Hellerstein, Georg W. Kofler & Ruth Mason, Constitutional Restraints on Corporate Tax Integration, 62 Tax. L. Rev. 1 (2008); see also Tom O'Shea, Dividend Taxation Post-*Manninen*: Shifting Sands or Solid Foundations?, 45 Tax Notes Int'l 887 (Mar. 5, 2007); Servaas van Thiel, The Taxation on Intra-Community Dividend Flows and the Avoidance of Double Taxation: The ECJ Takes the "Parent-Subsidiary Directive" Approach, in The Internal Market and Direct Taxation, note 17, at 113.

[110] See, e.g., Case C-251/98, Baars v. Inspecteur der Belastingdienst Particulieren, 2000 E.C.R. I-2787, ¶ 41; Case C-35/98, Staatssecretaris van Financiën v. Verkooijen, 2000

tax rate.[112] In addition that Member State may not otherwise discriminate against foreign source dividends as compared to domestic source dividends, but to the extent it does not treat domestic and inbound dividends differently, it is not under a Community law obligation to avoid juridical double taxation.[113]

With respect to outbound dividends, it was initially held by the EFTA Court that the prohibition of discrimination, in principle required that nonresident shareholders be granted the imputation credit that is available to domestic shareholders.[114] But the ECJ's decision in *ACT Test Claimants*[115] was more nuanced and for good reasons. It was clear from *Manninen* and *Fokus Bank* together that in the case of a cross-border dividend flow between two Member States that both apply the imputation method, the shareholder could be entitled to the imputation credit of both countries, thus obtaining an undue double advantage, with the source country effectively being obliged under Community law to give up its tax jurisdiction in respect of the profits realized by a foreign-owned domestic subsidiary. Thus the ECJ held that the Member State of the distributing company, in principle, would not be obliged to extend the benefit of the domestically applied imputation credit to nonresident shareholders if it refrained from imposing a withholding tax on the outbound dividends (because otherwise that Member State would have to waive its right to tax the domestic economic activity of the subsidiary).[116]

The court is likely to continue this, now settled, line of case law on taxation of cross-border dividends, because it follows, to a large ex-

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E.C.R. I-4071, ¶ 62; Case C-307/97, Compagnie de Saint-Gobain, Zweigniederlassung Deutschland v. Finanzamt Aachen-Innenstadt, 1999 E.C.R. I-6161, ¶ 63.

111 See, e.g., Case C-446/04, Test Claimants in the FII Group Litig. v. Commissioners of Inland Revenue, 2006 E.C.R. I-11753, ¶ 74; Case C-319/02, Manninen, 2004 E.C.R. I-7477, ¶ 55.

112 See, e.g., *Lenz*, 2004 E.C.R. I-7063, ¶ 49; Case C-334/02, Commission v. France, 2004 E.C.R. I-2229, ¶ 34.

113 See Case C-513/04, Kerckhaert & Morres v. Belgium, 2006 E.C.R. I-10967, ¶ 24.

114 See Case E-1/04, Fokus Bank ASA v. Norway, 1 C.M.L.R. 10 (Eur. Free Trade Area Ct. 2005), ¶ 38.

115 Case C-374/04, Test Claimants in Class IV of the ACT Group Litig. v. Commissioners of Inland Revenue, 2006 E.C.R. I-11673.

116 Id. ¶ 59.

> It must be held in that regard, first, that to require the Member State in which the company making the distribution is resident to ensure that profits distributed to a non-resident shareholder are not liable to a series of charges to tax or to economic double taxation, either by exempting those profits from tax at the level of the company making the distribution or by granting the shareholder a tax advantage equal to the tax paid on those profits by the company making the distribution, would mean in point of fact that that State would be obliged to abandon its right to tax a profit generated through an economic activity undertaken on its territory.

Id.

tent, the policy choices made by the Community legislator, who in the Parent-Subsidiary Directive also allows the state of the subsidiary to tax the profits of the subsidiary, but not the outbound dividends of the nonresident shareholder (withholding taxes as a rule must be abolished), while leaving the state of residence of the parent the choice of either exempting the dividends received from tax, or by taxing those dividends while providing an imputation credit (or indirect foreign tax credit) for the corporate income tax paid by the distributing subsidiary.[117]

Therefore criticism sometimes heard in the literature that the ECJ, in particular in its case law on economic double taxation of dividends, has taken the political decisions that should be reserved to the legislator, is misplaced.[118] In fact the court does not make the political choice that Member States must avoid economic double taxation of dividends as this is for the Member States to decide (to the extent the Community legislator has not acted) within the limits of Community law (such as the prohibition of discrimination).[119] Nor does the court decide that there should be one Community approach to eliminating economic double taxation of dividends because that is a choice that only the Community legislator can make.[120] The court merely carries out its function of preventing discrimination[121] by holding that, if a Member State chooses to eliminate economic double taxation on domestic dividends, it also must do so in respect of inbound dividends[122] and, sometimes also in respect of outbound dividends.[123] Moreover, in shaping this particular application of the nondiscrimination princi-

[117] See Council Directive 90/435, On the Common System of Taxation Applicable in the Case of Parent Companies and Subsidiaries of Different Member States, 1990 O.J. (L 225) 6, as amended by Council Directive 2003/123, 2004 O.J. (L 7) 41 [hereinafter Parent-Subsidiary Directive].

[118] 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 (2007).

[119] See, e.g., *ACT Group Litig.*, 2006 E.C.R. I-11673, ¶ 50 ("It is for each Member State to organise, in compliance with Community law, its system of taxation of distributed profits and, in that context, to define the tax base as well at the tax rates which apply to the company making the distribution and/or the shareholder to whom the dividends are paid, in so far as they are liable to tax in that State."); see also Case C-446/04, Test Claimants in the FII Group Litig. v. Commissioners of Inland Revenue, 2006 E.C.R. I-11753, ¶¶ 43-45; C-513/04, Kerckhaert & Morres v. Belgium, 2006 E.C.R. I-10967, ¶ 24.

[120] See, e.g., id. ¶¶ 22–23.

[121] See *FII Group Litig.*, 2006 E.C.R. I-11753, ¶ 45 ("However, in structuring their tax system and, in particular, when they establish a mechanism for preventing or mitigating the imposition of a series of charges to tax or economic double taxation, Member States must comply with the requirements of Community law and especially those imposed by the Treaty provisions on free movement."); see also *ACT Group Litig.*, 2006 E.C.R. I-11673, ¶ 55.

[122] See notes 110-12 and accompanying text.

[123] See Case E-1/04, Fokus Bank ASA v. Norway, 1 C.M.L.R. 10 (Eur. Free Trade Area Ct. 2005), ¶ 38. But see *ACT Group Litig.*, 2006 E.C.R. I-11673, ¶ 74 (holding that the

ple in the area of dividend taxation, the court follows as much as possible the political choices already made by the Council in the Parent-Subsidiary Directive.[124]

One open question is what the court's position will be if the Member State of the distributing company does impose a withholding tax on outbound dividends. From the case law it can be concluded that a Member State imposing a withholding tax on outbound dividends has to extend the imputation credit to nonresident shareholders.[125] What if that state, however, does not provide such a credit domestically? In that situation, case law suggests that the withholding tax risks being declared unconstitutional, unless the discriminatory effect of that withholding tax is neutralized because it is credited in the state of the shareholder (by means of a tax treaty-based direct foreign tax credit).[126] The withholding tax in that case would not constitute an exit obstacle, but rather would reflect the fact that two states had exercised their right to agree to a balanced allocation of tax jurisdiction that, in principle, would be without effect for the taxpayer concerned.[127]

There is one element in this line of case law that is more difficult to understand. In *FII Group Litigation* the court held that, when avoiding economic double taxation, the Member State of the shareholder was free to apply the exemption method domestically and the imputation credit method in respect of inbound dividend flows.[128] The court thereby recognized the different administrative burden on the shareholder receiving the inbound dividend, but declared this to be inher-

failure to extend an imputation credit to nonresident shareholders is not discriminatory if outbound dividends are not taxed).

124 Parent-Subsidiary Directive, note 117.

125 In *ACT Group Litigation*, 2006 E.C.R. I-11673, the ECJ held that whenever a source state applies a withholding tax to outbound dividends, it must extend its domestic measures to avoid economic double taxation to the nonresident shareholder. The ECJ also noted that under certain tax treaties the United Kingdom imposed a withholding tax on outbound dividends paid to a foreign shareholder, who, when holding less than 10%, did not qualify for the benefit of the imputation credit. Id. ¶ 19. Not extending the imputation credit to those foreign shareholders who pay the U.K. withholding tax constitutes an EC incompatible discrimination. Id. ¶ 70.

126 See, e.g., Case C-379/05, Amurta SGPS v. Inspecteur van de Belastingdienst/Amsterdam, 2007 E.C.R. I-9569, ¶ 61; Case C-170/05, Denkavit Internationaal BV v. Ministre de l'Économie, des Finances et de l'Industrie, 2006 E.C.R. I-11949, ¶ 41.

127 See *Amurta*, 2007 E.C.R. I-9569, ¶ 84; *Denkavit*, 2006 E.C.R. I-11949, ¶ 56. Both *Amurta* and *Denkavit* suggest that the discriminatory effects of a source state withholding tax can be neutralized by a tax treaty-based direct foreign tax credit. This logically follows the EFTA court, which in *Fokus Bank*, mainly focuses on the question of the indirect foreign tax credit or international imputation credit on outbound dividends, but only after having assumed that the source state withholding tax was neutralized by the residence state direct foreign tax credit. See *Fokus Bank*, 1 C.M.L.R. 10 (2005), ¶ 11.

128 Case C-446/04, Test Claimants in the FII Group Litig. v. Commissioners of Inland Revenue, 2006 E.C.R. I-11753, ¶ 43.

ent in the system and thus to be acceptable.[129] Moreover, the court recognized that the application of the ordinary tax credit would not necessarily allow the taxpayer to offset all the tax paid abroad, for example, if domestic tax payable on the income would have been lower than the foreign tax paid, but it correctly held that this would be due to the disparities between the tax systems of the Member States.[130] Surprisingly, however, the court ignored the potential cash flow disadvantage for the cross-border dividend flow (first pay tax and then receive credit) of this different treatment,[131] which had been the crux in *Metallgesellschaft & Hoechst*, in which the court had declared such a disadvantage for the cross-border situation to be EC incompatible.[132] In view of the court's consistent rejection of the de minimis justification and standard case law that any different treatment of similar situations constitutes discrimination, even if it merely risks working to the disadvantage of cross-border situations,[133] the court is expected to rectify this nuance, because it causes a distortion. Perhaps there was some confusion with the choice that the Member State of the parent has, under the Parent-Subsidiary Directive, to apply in respect of the inbound dividends an exemption or an ordinary indirect foreign tax credit (which is not the same as a choice of different tax treatment of domestic and inbound dividends).

IV. Possible Justifications for Discriminatory Exit or Access Taxes

A. *General Rules Were Developed, But Increasing Flexibility for Tax Cases*

According to settled internal market case law, the fundamental private sector rights to free movement and nondiscrimination must be

129 Id. ¶ 53.

130 Id. ¶ 52.

131 Later on in the decision the ECJ does consider the cash flow disadvantage of the optional "foreign income dividend" regime. Id. ¶¶ 145-47.

132 Joined Cases C-397/98 and C-410/98, Metallgesellschaft Ltd. & Hoechst AG v. Commissioners of Inland Revenue & H.M. Attorney Gen., 2001 E.C.R. I-1727, ¶ 76.

133 See Case 270/83, Commission v. France (*Avoir Fiscal*), 1986 E.C.R. 273, ¶ 21 (recalling that the Treaty prohibits all discrimination, even if only of a limited nature); see also Case C-231/05, Oy AA, 2007 E.C.R. I-6373, ¶¶ 40-41 (noting that it is irrelevant that the disadvantage would be small because it is sufficient that the contested measure is capable of restricting establishment); Case C-524/04, Test Claimants in the Thin Cap Litig. v. Commissioners of Inland Revenue, 2007 E.C.R. I-2107, ¶ 62 ("[I]t is sufficient that [the legislation] be capable of restricting the exercise of that freedom [of establishment] in a Member State by companies established in another Member State, and it is not necessary to establish that the legislation in question has actually had the effect of leading some of those companies to refrain from acquiring, creating or maintaining a subsidiary in the first Member State.").

interpreted widely and possible public interest justifications for discriminatory tax measures must be interpreted strictly.[134] Since the EC Treaty foresees no special status for direct taxes, this rule also would apply when those directly applicable private sector rights are invoked to challenge direct tax measures of the Member States.

One of the problems in the tax area, however, is that the traditional public interest grounds, which are mentioned in the Treaty (public sector jobs, public security, public health, and public policy), are of little use in cases concerning direct tax discrimination, because they are restrictively interpreted and because they exceptionally allow bans on access, but not discrimination, of inward economic activity once it has arrived on the host state market.[135] Even the explicit tax justifications in the Maastricht Treaty articles on the free movement of capital appear to have given little extra room for Member States to apply discriminatory anti-avoidance measures, because they were interpreted by the court as allowing different treatment of different situations, or different treatment of similar situations to the extent that this different treatment is justified by an overriding public interest.[136]

Because of this limited usefulness of Treaty justifications, the court has abandoned the assumption that discriminatory tax measures can be justified only on grounds explicitly mentioned in the Treaty, whereas only nondiscriminatory tax restrictions can be justified on wider public interest grounds.[137] Though still deciding in accordance with this traditional approach in *Commission v. France*,[138] the court, after having run into trouble in the *Daily Mail* case,[139] started investigating public interest justifications for tax discrimination in *Bachmann*.[140] Since that decision the court investigates practically all wider public interest justifications that are argued by Member States to justify instances of tax discrimination.

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134 See Servaas van Thiel, Justifications in Community Law for Income Tax Restrictions on Free Movement: Acte Clair Rules That Can Be Readily Applied by National Courts, pt. 1, 48 Eur. Tax'n 279, 279 (2008).

135 Id.

136 See, e.g., Case C-379/05, Amurta SGPS v. Inspecteur van de Belastingdienst/Amsterdam, 2007 E.C.R. I-9569, ¶ 32; Case C-265/04, Bouanich v. Skatteverket, 2006 E.C.R. I-923, ¶¶ 36-41; Case C-512/03, Blanckaert v. Inspecteur van de Belastingdienst, 2005 E.C.R. I-7685, ¶ 42; Case C-315/02, Lenz v. Finanzlandesdirektion für Tirol, 2004 E.C.R. I-7063, ¶¶ 24-27; Case C-319/02, Manninen, 2004 E.C.R. I-7477, ¶¶ 28-29; Case C-35/98, Staatssecretaris van Financiën v. Verkooijen, 2000 E.C.R. I-4071, ¶ 43.

137 See van Thiel, note 134; Servaas van Thiel, Justifications in Community Law for Income Tax Restrictions on Free Movement: Acte Clair Rules That Can Be Readily Applied by National Courts, pt. 2, 48 Eur. Tax'n 339 (2008).

138 *Avoir Fiscal*, 1986 E.C.R. 273.

139 Case C-81/87, The Queen v. H.M. Treasury, ex parte Daily Mail, 1988 E.C.R. 5483.

140 Case C-204/90, Bachmann v. Belgium, 1992 E.C.R. I-249.

B. *Justification Grounds Always Rejected by the ECJ*

In line with general internal market case law, the court does not accept a number of grounds for justification that are of an economic or administrative nature.

A first example is the argument that the discriminatory measure should be accepted because the disadvantage is avoidable, or compensated by an advantage. The court considers any restriction on free movement, even a minor one, prohibited, so that there is no room for a de minimis exception.[141] Moreover, the private sector must be free to choose how to conduct cross-border economic activities and its choices must not be distorted by the need to avoid disadvantages caused by discriminatory tax measures.[142] In the same logic the court has held that a discriminatory measure cannot be justified, either by the fact that it sometimes has a positive effect, or by the fact that the taxpayer concerned also may derive advantages from his special situation. In other words, compensation of the discriminatory disadvantage by other (potential) advantages is not possible.[143]

A second justification the court routinely has rejected is the need to avoid loss of revenue or to prevent the erosion of the tax base.[144] A nuance on this line of case law is the coherence justification which, although also having effect on a Member State's revenue flows (and in particular the timing thereof) allows a Member State to apply a restrictive tax measure if it is systematically tied to a subsequent measure that neutralizes its restrictive effect. The coherence justification was erroneously allowed by the Court in *Bachmann* because there were significant leaks in the systemic coherence of the Belgian tax system.[145] But it would be wrong to interpret *Bachmann* as an author-

[141] See note 133.

[142] See, e.g., Case C-250/95, Futura Participations SA & Singer v. Admin. des Contributions, 1997 E.C.R. I-2471; *Bachmann*, 1992 E.C.R. I-249; *Avoir Fiscal*, 1986 E.C.R. 273.

[143] See, e.g., Case C-379/05, Amurta SGPS v. Inspecteur van de Belastingdienst/Amsterdam, 2007 E.C.R. I-9569; Case C-35/98, Staatssecretaris van Financiën v. Verkooijen, 2000 E.C.R. I-4071; Case C-307/97, Compagnie de Saint-Gobain, Zweigniederlassung Deutschland v. Finanzamt Aachen-Innenstadt, 1999 E.C.R. I-6161; Case C-294/97, Eurowings Luftverkehrs AG v. Finanzamt Dortmund-Unna, 1999 E.C.R. I-7447; *Avoir Fiscal*, 1986 E.C.R. 273.

[144] See, e.g., Case C-196/04, Cadbury Schweppes plc v. Commissioners of Inland Revenue, 2006 E.C.R. I-7995; Case C-319/02, Manninen, 2004 E.C.R. I-7477; Case C-315/02, Lenz v. Finanzlandesdirektion für Tirol, 2004 E.C.R. I-7063; Case C-9/02, de Lasteyrie du Saillant v. Ministère de l'Économie, des Finances et de l'Industrie, 2004 E.C.R. I-2409; Case C-422/01, Försäkringsaktiebolaget Skandia v. Riksskatteverket, 2003 E.C.R. I-6817; Case C-385/00, De Groot v. Staatssecretaris van Financiën, 2002 E.C.R. I-11819; Case C-136/00, Danner, 2002 E.C.R. I-8147; *Verkooijen*, 2000 E.C.R. I-4071; *Saint-Gobain*, 1999 E.C.R. I-6161; Case C-264/96, Imperial Chem. Indus. plc v. Colmer, 1998 E.C.R. I-4695.

[145] For a detailed analysis of the Bachmann decision, see Servaas van Thiel, EU Case Law on Income Tax: Part I (2001).

ization by the court to allow the need to prevent potential revenue leaks as a possible justification for discrimination under the new label "coherence of the tax system." This was made clear in subsequent case law in which the potential scope of this possible justification was significantly reduced on the argument that there must be a direct (systematic) link between the initial measure revenue (resulting in forgone), and a subsequent measure (resulting in a future possible loss of revenue), and the measures taken must be proportional.[146] In addition, the ECJ clarified that coherence can only be successfully relied upon in an individual case if not already guaranteed on a broader, tax treaty level.[147] In reality the court rejected the coherence justification in all subsequent cases in which Member States tried to rely on that argument merely to protect their revenue base. Only exceptionally, and to the extent that the coherence of a tax system is systemic, can it constitute an acceptable justification for a measure that prima facie seems to be disadvantageous for a cross-border situation, but upon closer look, is directly linked to another measure that neutralizes this disadvantage. This was recently confirmed by the ECJ in *Papillon*[148] in which a French tax measure, that allowed loss compensation between a domestic parent and a domestic subsidiary, but not if the domestic (sub-)subsidiary was indirectly owned by another subsidiary established in another Member State, was considered justified by the court. The reason was the systemic link in the French tax system between allowing the French subsidiary to push its losses to the parent, and simultaneously disallowing the parent to reduce the book value of its participation in the (loss-making) subsidiary. That systemic link, which avoided the use of losses twice, would be broken if the French (sub-)subsidiary were held by another subsidiary in another Member State. The ECJ thus accepted the coherence justification, but nevertheless considered the French rule disproportional because the taxpayer was not allowed to provide evidence that he did not benefit from a double deduction of losses.[149]

To be distinguished from the coherence justification (which concerns the coherence of the tax system of one Member State), is the agreed coherence between two Member States on the allocation of tax

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[146] In several cases, the court saw no direct link. See, e.g., *Manninen*, 2004 E.C.R. I-7477; *Verkooijen*, 2000 E.C.R. I-4071; Case C-251/98, Baars v. Inspecteur der Belastingdienst Particulieren, 2000 E.C.R. I-2787; Case C-55/98, Skatteministeriet v. Vestergaard, 1999 E.C.R. I-7641; *Eurowings*, 1999 E.C.R. I-7447; *Imperial Chem.*, 1998 E.C.R. I-4695; Case C-107/94, Asscher v. Staatssecretaris van Financiën, 1996 E.C.R. I-3089.

[147] Case C-80/94, Wielockx v. Inspecteur der Directe Belastingen, 1995 E.C.R. I-2493.

[148] Case C-418/07, Société Papillon v. Ministère du Budget, 2008 E.C.R._____, available at http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:62007J0418:EN:HTML.

[149] Id. ¶¶ 41-50.

jurisdiction, which in itself can be an acceptable justification, because the agreement with another Member State may eliminate the disadvantage for the cross-border situation.[150]

A third example of rejected grounds for justification is the need to avoid administrative difficulties and to ensure an effective fiscal supervision and control with a manageable administrative collection and enforcement burden. Though the effectiveness of fiscal controls was recognized by the ECJ as a legitimate objective,[151] it cannot justify discrimination, because Member States can overcome their administrative challenges by requesting the taxpayer to supply all necessary information or exchanging information with each other.[152]

In conclusion, the court, though readily assessing the broader public interest arguments on the basis of which the Member States have tried to justify their discriminatory tax measures, has always been very cautious in actually allowing discriminatory tax measures on such broader public interest grounds.

C. *Justification Grounds that Are Acceptable to the ECJ*

The court recently has revisited its previous position as regards two possible justifications for discriminatory or restrictive tax measures: the need to prevent tax avoidance and evasion and the need to ensure a balanced allocation of tax jurisdiction.[153] That the ECJ has been making quite a movement in the direction of Member States on these two points is clear if one recalls the orthodox starting position in *Commission v. France*: (1) The contested measure could not be justified by the need to prevent tax evasion and avoidance because the Treaty did

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150 See text accompanying notes 126-27. This also explains why I cannot accept the suggestion by Wattel that coherence and balanced allocation of tax jurisdiction are the same. See Peter Wattel, Fiscal Cohesion, Fiscal Territoriality and Balanced Allocation of Tax Jurisdiction: What is the Difference? (2008), available at http://european-tax-adviser.com/wordpress/wp-content/uploads/2007/08/ac2006_wattel.pdf. The first is an autonomous revenue protection argument that comes with discrimination. The second is an "agreed allocation of tax jurisdiction" argument that ensures that the initial discriminatory effect of the tax measure of one Member State is neutralized by the agreed action undertaken by the other Member State.

151 Case 120/78, Rewe-Zentral AG v. Bundesmonopolverwaltung für Branntwein (*Cassis de Dijon*), 1979 E.C.R. 649.

152 See Case C-39/04, Laboratoirs Fournier SA v. Direction des Vérifications Nationales et Internationales, 2005 E.C.R. I-2057, ¶¶ 22–26; *Manninen*, 2004 E.C.R. I-7477, ¶¶ 50–55; Case C-334/02, Commission v. France, 2004 E.C.R. I-2229, ¶¶ 29–34; Case C-324/00, Lankhorst-Hohorst GmbH v. Finanzamt Steinfurt, 2002 E.C.R. I-11779, ¶ 44; Case C-435/00, X and Y v. Riksskatteverket, 2002 E.C.R. I-10829, ¶¶ 61–63; Case C-55/98, Skatteministeriet v. Vestergaard, 1999 E.C.R. I-7641, ¶¶ 25–28; Case C-254/97, Societe Baxter v. Premier Ministre, 1999 E.C.R. I-4809, ¶¶ 18-21; Case C-250/95, Futura Participations SA & Singer v. Admin. des Contributions, 1997 E.C.R. I-2471, ¶¶ 39–41.

153 See notes 156-62 and accompanying text.

not provide for such a justification;[154] and (2) the French argument, that unilaterally extending the benefit of the imputation credit to all nonresident European taxpayers would upset the "quid pro quo" balance of France's tax treaties, had to be rejected because Community law applied without condition of "quid pro quo" reciprocity.[155]

In a subsequent line of steady case law, the court accepted that restrictive anti-avoidance measures can exceptionally be justified if they are specifically targeted at wholly artificial constructions without economic substance that seek to avoid the tax burden that otherwise would apply.[156] In this respect the court has clarified that an arrangement is wholly artificial if it does not involve the pursuit of an actual economic activity, such as "letterbox" companies that are considered to be without economic substance.[157] On the other hand, the arrangement is not wholly artificial if the legal construction, such as the incorporation of a controlled foreign corporation, reflects economic reality, which is the case for companies that physically exist in the host state "in terms of premises, staff and equipment."[158] The ECJ leaves it to the national courts to weigh the evidence on whether a structure is wholly artificial and without economic substance, and to decide whether national anti-avoidance measures are specifically targeted at such constructions.[159] In doing so, national courts should decide on a case-by-case basis, and take account of the general principle to strictly interpret possible justifications as well as of the proportionality requirement, and private sector operators who are denied their Community rights should have access to judicial appeal (due process).[160]

More recently, the court also has accepted that a balanced allocation of tax jurisdiction may neutralize the discriminatory effect of a tax measure of one Member State, thus justifying its continued application because in the end there is no discrimination. The argument has arisen both in the context of an agreed balanced allocation of tax jurisdiction in tax treaties,[161] as well as more general shared autono-

154 Case 270/83, Commission v. France (*Avoir Fiscal*), 1986 E.C.R. 273, ¶ 25.

155 Id. ¶ 26.

156 See Case C-231/05, Oy AA, 2007 E.C.R. I-6371, ¶¶ 58–65; Case C-196/04, Cadbury Schweppes plc v. Commissioners of Inland Revenue, 2006 E.C.R. I-7995, ¶¶ 55–56; Case C-446/03, Marks & Spencer plc v. Halsey, 2005 E.C.R. I-10837, ¶¶ 49–57.

157 See *Cadbury Schweppes*, 2006 E.C.R. I-7995, ¶ 68.

158 Id. ¶ 67.

159 See id. ¶¶ 72, 75.

160 See id.

161 See Case C-379/05, Amurta SGPS v. Inspecteur van de Belastingdienst/Amsterdam, 2007 E.C.R. I-9569, ¶ 84; Case C-170/05, Denkavit Internationaal BV v. Ministre de l'Économie, des Finances et de l'Industrie, 2006 E.C.R. I-11949, ¶ 56.

mous understandings of the proper allocation of tax jurisdiction.[162] The starting point of this reasoning is the *Gilly* understanding that tax treaty rules on the allocation of tax jurisdiction between Member States are always allowed because they determine where an income flow will be taxed and do not cause discrimination.[163] One step further is the understanding that a measure of one Member State may, regarded on its own, be discriminatory against cross-border income flows, but that this effect is neutralized by an agreed measure applied by the other Member State. A clear example is the withholding tax of a source Member State that is neutralized by a direct foreign tax credit of the residence Member State.[164] Outside the scope of tax treaties there are other basic rules on allocation of tax jurisdiction that the ECJ seems to respect, and on the basis of which it considers a restrictive measure as possibly justified. The lead example is the *Marks & Spencer* understanding that Community law should not have the effect that a Member State can no longer tax domestic source income realized by resident taxpayers (repeated in *Cadbury Schweppes* and *ACT Test Claimants*).[165] But this "balanced allocation of tax" justification cannot be understood as allowing the continued application of a discriminatory national tax measure until a tax treaty has been negotiated that takes this discrimination away. In other words the discrimination in cases such as *Commission v. France*[166] and *Saint-Gobain*[167] could not be justified on this basis.

D. Possible Future Developments

From the above it can be concluded that the ECJ can be expected to continue to be very skeptical towards many of the "overriding public interest" justifications argued by Member States with a view to being authorized under Community law to continue to apply tax measures that discriminate against cross-border intra-Community economic activity. In fact the ECJ has firmly rejected most of the grounds invoked by the Member States and the court is likely to continue to reject attempts by Member States to justify discrimination on economic or

[162] See Case C-446/03, Marks & Spencer plc v. Halsey, 2005 E.C.R. I-10837, ¶¶ 43–46; see also Test Claimants in Class IV of the ACT Group Litig. v. Commissioners of Inland Revenue, 2006 E.C.R. I-11673, ¶ 59; *Cadbury Schweppes*, 2006 E.C.R. I-7995, ¶ 56.

[163] See Case C-336/96, Gilly v. Directeur des Services Fiscaux du Bas-Rhin, 1998 E.C.R. I-2793, ¶ 30.

[164] See *Amurta*, 2007 E.C.R. I-9569, ¶ 84; *Denkavit*, 2006 E.C.R. I-11949, ¶ 56.

[165] See *Marks & Spencer*, 2005 E.C.R. I-10837, ¶¶ 43-46; see also *Cadbury Schweppes* 2006 E.C.R. I-7995, ¶ 56; *ACT Group Litig.*, 2006 E.C.R. I-11673, ¶ 59.

[166] Case 270/83, Commission v. France (*Avoir Fiscal*), 1986 E.C.R. 273.

[167] Case C-307/97, Compagnie de Saint-Gobain, Zweigniederlassung Deutschland v. Finanzamt Aachen-Innenstadt, 1999 E.C.R. I-6161.

budgetary grounds (including loss of revenue, erosion of the tax base, and nonsystematic but mere revenue coherence of the tax system),[168] as well as on administrative grounds (lack of information, difficulties with assessing or collecting the tax, and administrative convenience).[169] And this is perfectly in line with the broader internal market case law which the court has developed over years and long before income tax cases came to the court.

The ECJ, however, can be expected to continue to allow Member States, under the control of national courts, to apply their national anti-avoidance clauses to wholly artificial constructions without economic substance aimed at avoiding tax. There is likely to be future case law on the exact meaning of such an empty legal construction and national courts initially will have difficulty applying the rather strict Community law test for such an empty construction (no economic activity whatsoever),[170] as they have been used to applying national anti-avoidance measures that target tax planning constructions that simply benefit from lower tax burdens in other Member States, while having economic substance. Moreover, it is, for the moment, unclear why the ECJ chose not to apply this sophisticated approach to anti-avoidance clauses in tax treaties.[171] The court is likely to fine-tune the *ACT Test Claimants* decision (which was not extensively motivated) so as to come to the conclusion that limitation of benefit clauses (as well as other tax treaty-based anti-avoidance clauses) are justified to the extent they target wholly artificial constructions, such as empty conduit companies, that were set up only to have access to benefits provided in tax treaties that otherwise would not apply to the beneficial owner (tax treaty shopping). Again the court can be expected to refer to national courts to decide whether the tax treaty-based anti-avoidance measures remain within Community law parameters.

The ECJ also can be expected to continue to allow Member States to ensure compliance with Community law either by means of their national laws or by concluding a tax treaty with another Member State ensuring a balanced allocation of tax jurisdiction. In this respect the court is likely to continue to accept all conflict rules in tax treaties that allocate tax jurisdiction and abolish double taxation,[172] because they

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[168] See Case C-319/02, Manninen, 2004 E.C.R. I-7477, ¶¶ 40–49; Case C-315/02, Lenz v. Finanzlandesdirektion für Tirol, 2004 E.C.R. I-7063, ¶¶ 34–39; Case C-35/98, Staatssecretaris van Financiën v. Verkooijen, 2000 E.C.R. I-4071, ¶¶ 49–51.

[169] See discussion in Section IV.B.

[170] For cases applying the test, see note 156.

[171] See Case C-374/04, Test Claimants in Class IV of the ACT Group Litig. v. Commissioners of Inland Revenue, 2006 E.C.R. I-11673, ¶¶ 89–92.

[172] See Case C-336/96, Gilly v. Directeur des Services Fiscaux du Bas-Rhin, 1998 E.C.R. I-2793, ¶¶ 23–25.

merely affect inter-jurisdictional equity (division of revenue between Member States) without distorting taxpayer equity (tax burden of individual taxpayers) and thus free movement on the internal market.[173] The court also is likely to accept the combined application of source state withholding taxes (although potentially discriminatory) and residence state direct foreign tax credits (taking away the discriminatory effect of the withholding tax) as affecting only interjurisdictional equity, and thus justified on the ground of a balanced allocation of tax jurisdiction.[174] The court, moreover, probably will continue to allow Member States the freedom to choose between the exemption or credit method of avoiding double taxation as long as these methods are not applied in such a way that a cross-border taxpayer loses benefits that were available to him in a single tax jurisdictions,[175] and as long as the method chosen is applied in the same way to all similar situations.[176] The court also can be expected to continue its line that substantive tax benefits foreseen by domestic law no longer can be granted to nonresidents on the basis of reciprocity, because directly applicable Community law requires that they should be available to all cross-border taxpayers in a similar situation as domestic taxpayers, except that the Member State providing for the substantive benefit may not be obliged to extend that benefit to the nonresident if that nonresident has the same benefit in his state of residence.[177]

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[173] Id. ¶¶ 44–48.

[174] Case C-170/05, Denkavit Internationaal BV v. Ministre de l'Économie, des Finances et de l'Industrie, 2006 E.C.R. I-11949, ¶ 43; Case C-379/05, Amurta SGPS v. Inspecteur van de Belastingdienst/Amsterdam, 2007 E.C.R. I-9569, ¶¶ 56–60. These cases suggest that the discriminatory effect of a source state withholding tax may be neutralized by a tax treaty-based credit, even though that condition was fulfilled neither in *Denkavit* (because in spite of the tax treaty the Netherlands applied an exemption instead of a tax credit) nor in *Amurta* (because there was no tax treaty between the Netherlands and Portugal).

[175] See Case C-385/00, De Groot v. Staatssecretaris van Financiën, 2002 E.C.R. 11819, ¶ 86; *Gilly*, 1998 E.C.R. I-2793, ¶ 47 ("[A]ny unfavourable consequences entailed in the present case by the tax credit mechanism set up by the bilateral convention, as implemented in the context of the tax system of the State of residence, are the result in the first place of the differences between the tax scales of the Member States concerned, and, in the absence of any Community legislation in the field, the determination of those scales is a matter for the Member States."). In *de Groot*, the *Gilly* understanding, that the credit method to avoid double taxation is acceptable (because merely resulting in disparities and not in discrimination), did not apply because the way in which the Dutch credit was applied resulted in discrimination (a loss of the right to deduct expenses) and not merely in disparities. *De Groot*, 2002 E.C.R. 11819, ¶ 87.

[176] Cf. Case C-298/05, Columbus Container Servs. BVA v. Finanzamt Bielefeld-Innenstadt, 2007 E.C.R. I-10451, ¶¶ 39–41 (reiterating settled case law acknowledging that discrimination can arise through either applying different rules to similar situations or the same rule to different situations).

[177] Case C-446/03, Marks & Spencer plc v. Halsey, 2005 E.C.R. I-10837, ¶¶ 54–57; Case C-279/93, Finanzamt Koln-Alstadt v. Schumacker, 1995 E.C.R. I-225, ¶¶ 45–47.

The end result of this consistent line of case law is that the ECJ largely accepts the traditional views of Member States on the proper allocation of tax jurisdiction and the respective responsibilities for avoiding double taxation, unless these traditional views result in discrimination against the cross-border activity as compared to the domestic activity.[178] In that case the combined failure of the two Member States concerned causes an exit restriction in the home state and an access restriction in the host state. This is why I expect the court, in due time, to reverse its recent line that substantive benefits that are foreseen by tax treaties can be granted on a strict bilateral basis on the ground that they form part and parcel of the "quid pro quo" balance of the tax treaty.[179] The reason is that any variation in these substantive benefits goes beyond shaping inter-jurisdictional equity (the allocation of revenue) and does affect taxpayer equity (the actual tax burden on and thus ability to pay of the taxpayer). The same is true for the reasoning in *ACT Test Claimants* that tax treaty benefits can be reserved to residents that are controlled domestically, but not to residents that are controlled by nationals or companies of other Member States,[180] as this would allow a Member State to discriminate, contra legem,[181] against foreign controlled subsidiaries, whereas they could not do so against foreign-owned branches.[182]

V. Final Observations

A. *The Starting Point and the Clear Lines of Case Law*

The internal market case law of the ECJ warrants the overall conclusion that directly applicable Community provisions on free movement and nondiscrimination have a wide scope of application. The

[178] See notes 156–62 and accompanying text.

[179] For cases reflecting the court's current trend, see Case C-374/04, Test Claimants in Class IV of the ACT Group Litig. v. Commissioners of Inland Revenue, 2006 E.C.R. I-11673, ¶¶ 79-91; Case C-446/04, Test Claimants in the FII Group Litig. v. Commissioners of Inland Revenue, 2006 E.C.R. I-11753, ¶¶ 47–53 (holding that it is acceptable under EC law to use an imputation system to relieve the taxation of dividend income sourced in another Member State and to use an exemption system for domestic sourced dividends); Case C-376/03, D. v. Inspecteur van de Belastingdienst/Particulieren/Ondernemingen Buitenland te Heerlen, 2005 E.C.R. I-5821, ¶¶ 49–63 (holding that residents of a Member State that does not have a tax treaty with another Member State are not in a similar situation to residents of another Member State that does have a tax treaty with the first Member State).

[180] See *ACT Group Litig.*, 2006 E.C.R. I-11673, ¶¶ 89-92 (involving limitation of benefits clauses).

[181] See EC Treaty, note 4, art. 294 (requiring nondiscrimination against Member State nationals as shareholders).

[182] See Case C-307/97, Compagnie de Saint-Gobain, Zweigniederlassung Deutschland v. Finanzamt Aachen-Innenstadt, 1999 E.C.R. I-6161, ¶¶ 47–63.

private sector rights that flow from these provisions[183] in principle can be invoked by all Community citizens and companies engaging in an intra-Community cross-border activity aimed at earning income and by all European citizens moving across intra-Community borders. From the direct tax case law it is clear that the EC Treaty does not foresee a carve-out, or a sovereignty exception, or any other special status for income taxation.[184] This means that the way in which both the home Member State and the host Member State tax cross-border income flows between Community subjects, must be "constitutionally sound," and that direct tax measures can be tested on their compatibility with Community law in general and the private sector rights to free movement and nondiscrimination in particular.

From the solid lines of direct tax case law on prohibited exit and access restrictions, it is clear that any higher taxes imposed on cross-border activity as compared to similar domestic activity constitute prohibited discrimination irrespective of whether imposed by the home state on persons who want to be economically active in another Member State, or by the host state on those seeking access to that market.[185] Crystal clear lines of case law have developed on prohibited exit taxes that result from the definition of taxable income items (capital gains taxable only on exit), exemptions (only domestic source income exempt), deductible expenses (only domestic costs are deductible), tax rates (higher rates on foreign source income or foreign-owned establishments), tax credits (imputation credits, foreign tax credits, and incentive credits), and tax procedures.[186] Likewise, solid lines of case law have developed on prohibited access taxes (also covering definitions of tax base, rates, credits, and procedures) that cause a higher tax burden on foreign-owned permanent establishments and subsidiaries, or on incoming frontier workers or professionals (including the deductions for personal and family expenses and business expenses).[187]

It is also very clear that the continued application of discriminatory tax measures can be justified only in exceptional cases in which there are overriding public interest reasons to do so, for instance the need to combat tax avoidance and evasion and the need to respect the (agreed) balanced allocation of tax jurisdiction.[188]

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[183] See note 32 and accompanying text.

[184] See Case C-279/93, Finanzamt Köln-Alstadt v. Schumacker, 1995 E.C.R. I-225, ¶ 20; Case 270/83, Commission v. France (*Avoir Fiscal*), 1986 E.C.R. 273, ¶ 26.

[185] See discussion in Sections III.A, Section III.B.

[186] See discussion in Section III.A.

[187] See discussion in Section III.B.

[188] See discussion in Section IV.A.

B. The Cyclical Pattern

In spite of these clear orientation points, a broad cyclical pattern can be seen in the body of income tax case law that developed over the last twenty years, in which the ECJ was rather prudent in an initial phase, but subsequently broadly applied the internal market principles developed in settled case law to the income tax area.[189] Since 2005, however, the court has become more cautious again and this is illustrated by all the main questions that arise in each income tax case:[190] whether Community law is applicable, whether the contested tax measure constitutes discrimination, and whether the continued application of that measure nevertheless can be justified by overriding public interest grounds.

Though no doubt welcome to Member States as a correct rebalancing by the court of "internal market interests" against the "tax sovereignty interests" of the Member States, a thorough analysis of the recent case law shows that this new caution has been unnecessary in most cases, while resulting in conceptual confusion and potential distortions of the internal market.

This is first of all true for the more dubious line of recent case law on taxpayer access to Community law, which broadened the exclusion of third country corporate groups from the benefits of Community law, not only if they sought to have access directly from the third country to the Community market (inbound services and establishment), but also if they acted by means of intra-Community transactions between two group members who themselves were qualifying companies.[191] In fact the court has gone so far as to qualify an intra-Community cross-border capital movement between two qualifying persons as an inward establishment into the Community by their common third country parent.[192] This new line is unsustainable in the light of other case law, and because it uses the control criterion, whereby qualifying creditors and debtors in an intra-Community loan, run the risk of being excluded from the scope of Community law if they are both controlled by a third country parent. Moreover, the legal basis and reasoning for requalifying an interest payment between *Community Company A* and *Community Company B* as an inward establishment into the Community by their common third country parent, is mind boggling. A return by the court to a more traditional

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[189] See note 18 and accompanying text.

[190] See note 20 and accompanying text.

[191] See discussion in Section II.C.

[192] Case C-524/04, Test Claimants in the Thin Cap Group Litig. v. Commissioners of Inland Revenue, 2007 E.C.R. I-2107.

approach towards third country persons should be expected.[193] This, however, should not affect the conclusion that neither inward establishment/supply of services from a third country into the EU, nor outbound establishment/supply of services from the EU towards a third country are eligible for EC Treaty benefits (until so provided for in the EU GATS schedule of commitments or bilateral treaties), which the court confirmed in recent income tax cases.[194]

Conceptual confusion also resulted from the basic policy choice of the court, when investigating the EC compatibility of a direct tax measure, to focus exclusively on national treatment, while ignoring Member States' internal market obligations to provide most favored nation treatment and to prevent unnecessary dual burdens.[195] In view of the fact that (1) the bulk of tax treaty provisions will survive an MFN and prevention of dual burden obligation anyway (because they concern allocation of tax jurisdiction and avoidance of double taxation), that (2) the exclusive focus on national treatment causes serious inconsistencies between the direct tax case law and the broader internal market case law, and that (3) this specific direct tax line may cause substantial distortions on the internal market (which was completed in 1993), the court, in the end, is expected to also condemn host state tax treaty measures that discriminate between similar incoming economic activities originating from different home states, or that hinder market access by causing an unnecessary double burden.

Finally, the recent trend to consider all tax treaty clauses outside the scope of the prohibition on discrimination (hidden sovereignty exception for tax treaties), on the ground that a taxpayer covered by a tax treaty is never in a similar situation as a taxpayer not covered by that particular tax treaty (weak substantive argument)[196] is unsustainable. The court should return to its more traditional understanding that Member States may freely conclude tax treaties and decide on the criteria for allocating tax jurisdiction, but that tax treaties can neither give rise to nor justify an EC-incompatible discrimination. Therefore substantive tax benefits foreseen for residents cannot be granted or denied on the basis of reciprocity, but, on the basis of Community law, must be extended to all nonresident taxpayers in a similar position as resident taxpayers. Also substantial tax treaty benefits cannot be

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[193] See, e.g., Case C-1/93, Halliburton Servs. BV v. Staatssecretaris van Financiën, 1994 E.C.R. I-1137 (holding that the parent company being organized outside of Member States does not preclude Community law from applying to subsidiaries organized in Member States).

[194] Case C-102/05, Skatteverket v. A and B, 2007 E.C.R. I-3871; Case C-415/06, Stahlwerk Ergste Westig GmbH v. Finanzamt Dusseldorf-Mettman, 2007 E.C.R. I-151.

[195] See Case C-376/03, D. v. Inspecteur van de Belastingdienst, 2005 E.C.R. I-5821.

[196] See notes 47-48 and accompanying text.

granted to nonresidents on a strictly bilateral basis. This return to a more traditional internal market logic will not mean the end to tax treaties. In fact, it only means that the court will have to clarify the difference between substantive tax treaty and conflict rules, and in that process it will become clear that the bulk of the tax treaty provisions will qualify under the *Gilly* rule,[197] including the agreed combined application by the source state of withholding taxes and by the residence state of a credit to avoid double taxation, because the essential effect of these rules is to share revenue between tax jurisdictions rather than to differentiate the tax burden of the cross-border as compared to the domestic taxpayer.

On the other hand, some recent cyclical developments in the area of justifications are welcome. For instance, recent case law on the tax avoidance justification is positive to the extent it allows a restrictive national anti-avoidance measure if it is specifically aimed at preventing the use of wholly artificial arrangements without economic substance with a view to circumventing national tax law.[198] The court is developing a useful and balanced approach that will allow Member States to distinguish between genuine cross-border economic activities (including those that seek to benefit from a better tax climate abroad),[199] and tax avoidance and evasion constructions that would not exist if it were not for the objective of escaping home country taxes. But this justification does, and should have it limits, and the court went too far when it noted in passing in *ACT Test Claimants* that limitation-on-benefit clauses were part of the balance of the tax treaty and not contrary to the Treaty freedoms.[200] After all, LOB clauses are treaty-based, anti-avoidance measures and, like all anti-avoidance measures, they should pass the (proportionality) test of whether they cover only wholly artificial arrangements without economic substance. One can not possibly say that all Dutch holding companies of European multinationals lack economic substance, but they are excluded from treaty benefits under tax treaty-based LOB clauses, and this constitutes an internal market incompatible discrimination between two resident companies on the basis of the seat of their parent company, a discrimination routinely condemned by the court itself.[201] And should

[197] See Case C-336/96, Gilly v. Directeur des Services Fiscaux du Bas-Rhin, 1998 E.C.R. I-2793.

[198] See note 156 and accompanying text.

[199] See Case C-196/04, Cadbury Schweppes plc v. Commissioners of Inland Revenue, 2006 E.C.R. I-7995.

[200] Case C-374/04, Test Claimants in Class IV of the Act Group Litig. v. Commissioners of Inland Revenue, 2006 E.C.R. I-11673, ¶ 96.

[201] See, e.g., Joined Cases C-397/98 and C-410/98, Metallgesellschaft Ltd. & Hoechst AG v. Commissioners of Inland Revenue & H.M. Attorney Gen., 2001 E.C.R. I-1727; *Open Skies* cases, note 53.

a Member State now be allowed to exclude a Dutch national who is resident in the Netherlands from the benefits of the Dutch-U.S. tax treaty because his father is an Italian worker, who after twenty years of service in the Netherlands returned home? Surely there are less restrictive ways to prevent tax treaty shopping.

Likewise the development of the concept of "a balanced allocation of tax jurisdiction"[202] is very interesting, because it recognizes that Member States can lift domestic measures up into the sphere of an agreed coordination of their tax systems, with the result that those tax measures are no longer EC incompatible. For instance, the imposition of withholding taxes is almost by definition a potentially discriminatory exercise, but if lifted up into a balanced allocation of tax jurisdiction, and matched with a credit in the state of the recipient of the income, it loses its discriminatory character. The same is true for different withholding taxes applied in different bilateral situations. If not matched with credits, these constitute discriminatory measures (denial of most favored nation treatment), which distort free movement in the internal market, but if part of a balanced allocation of tax jurisdiction, the discrimination disappears. This is probably the reason why Article 23 of the OECD Model Convention,[203] though allowing States in principle to choose between the exemption or the credit method to avoid juridical double taxation, always prescribes the credit method for source state withholding taxes on cross-border dividends, interests, and royalties. Again, however, this justification does, and should have it limits, and the court goes too far in accepting practically anything that Member States put in a tax treaty. In this respect the overall balance of the tax treaty depends on the allocation of tax jurisdiction between the contracting parties (the bilateral shaping of inter-jurisdictional equity that is neutral from an internal market point of view), but this should not be confused with tax treaty clauses that reserve substantive tax advantages for bilateral relationships and that discriminate against all other potential market participants (distorting taxpayer equity).

Finally, I am not convinced by suggestions in the literature that the balanced allocation of tax jurisdiction (which matches two tax systems) is essentially the same as coherence of the tax system (which considers only one tax system) and territoriality of the tax system (which is based on the OECD assumption that I can do what I want).[204] Nor do I agree that, therefore, the court should allow the Member States to fence off their tax systems and return to the good

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[202] *ACT Group Litig.*, 2006 E.C.R. I-11673, ¶ 65.

[203] OECD Model Treaty, note 56, art. 23.

[204] See Wattel, note 150.

old days of unlimited sovereignty when Member states were free to do what they wanted, including defining their tax jurisdiction in such a way (taxing residents on worldwide income and nonresidents on domestic source income) that double taxation necessarily occurs, distinguishing between incoming economic activities on the basis of their place or origin, and treating domestic situations better than cross-border situations. The Commentary to the OECD Model Convention is filled with this kind of "only mind your own business" rules,[205] which is perfectly understandable in an international context, but perfectly incompatible with a deep economic integration process such as the one set up by the political masters in Europe.

C. *Does the ECJ Go Beyond its Constitutional Role?*

The criticism in academic[206] and political discussions[207] that the ECJ would go beyond its constitutional role, is without substance. It often refers to "judicial activism" in a negative way as if European judges were initiating an entire re-organization of the tax systems of the Member States,[208] and in fact is largely based on the assumption that the ECJ, in one way or another, takes away the taxing powers of the Member States.[209] Both points are far from the truth. European judges become active only if requested to do so by private parties who consider that their constitutional rights are violated, or by the Commission, which believes that one or the other Member State is acting contrary to its obligations under Community law. Subsequently, the idea that European courts would take away taxing powers is incorrect, as it fails to distinguish between the power to tax (exclusive compe-

205 OECD Model Treaty, Commentary, available at http://ip-online2.ibfd.org/data/treaty/docs/pdf/tt_02.02_eng_2005_cm_2.pdf (subscription required).

206 See, e.g., Kofler, note 21, at 39.

207 See, e.g., The European Court in the Limelight—Again, 45 Common Mkt. L. Rev. 1571 (2008); Fred. C. de Hosson, On the Controversial Role of the European Court in Corporate Tax Cases, 34 Intertax 294 (2006); Willem Vermeend, The Court of Justice of the European Communities and Direct Taxes: "Est-ce que la justice est de ce monde"?, 5 EC Tax Review 54 (1996).

208 See, e.g., Daniel Gutmann, Some Theoretical Thoughts on Judicial Power and Tax Law, with Particular Focus on the ECJ, in A Vision of Taxes Within and Outside European Borders, note 21, at 485; Mason, note 21; Ulrich Forsthoff, EuGH versus Europäischer Gesetzgeber—oder Freiheiten über alles, 14 Internationales Steuerrecht 222 (2006); Karin-Renate Ahmann, Das Ertragssteuerrecht unter dem Diktat der Europäischen Gerichtshofs?-Können wir uns wehren?, 93 Deutsche Steuerzeitung 75 (2005).

209 A colorful combination of fundamental misunderstandings of the constitutional principles of Community law can be found in Graetz and Warren, note 21, at 1207, in which it is suggested that "ECJ decisions to date suggest potentially staggering constraints on countries' freedom to resolve what strike us as quintessentially legislative issues—constraints that are fundamentally inconsistent with the fiscal autonomy retained by the member states in their right to veto EU taxing provisions." This is a political judgment without much legal basis.

tence of the Member States), the power to regulate in the area of taxation (competence shared between EU and national legislator), and the power to test the constitutionality of the way in which these powers of taxation and regulation are exercised (ECJ and domestic courts). The ECJ is neither taking away the taxing powers of the Member States nor is it itself legislating in the tax area.[210] Instead, much in the same way as any domestic constitutional court, the ECJ tests the way in which the Member States exercise their taxing powers against the constitutional margins of EC law, in particular, the private sector rights to free movement and nondiscrimination in the internal market. In light of the overall internal market case law, there is not much new in the income tax case law of the court, and if anything is new, it is not that the court has lost all constraint, but rather that the court is much more cautious in its income tax case law than it is in other areas of internal market case law.[211] Any judge knows that deciding cases inevitably involves making choices and that, particularly in the tax area, such choices can have important consequences, but that fact does not mean that judges do not have the obligation to decide, in one way or another. It should be no surprise that European judges decide in the constitutional framework of the treaty that sets up a deep integration process between European States.[212] In this framework it is not the constitutional role of the European judge to "balance the internal market" against the "fiscal sovereignty" or "budgetary concerns" of the Member States. Expecting a European judge to do that is turning the world upside down; in the European constitutional set-up it is for the Member States, including their finance ministries, to act within the framework of Community law and to pay the price if they act illegally. It is for the ECJ to protect private sector rights against the illegal collection of taxes by Member States. Neither one Member State, nor groups of disgruntled Member States can change this constitutional reality. It can be changed only by all Member States acting together as the European constitutional legislator. The fact is, however, that the constitutional legislator has chosen up to six times, between 1957 and 2007, not to change the constitutional set-up of the Communities and not to create a special status for

[210] In fact the ECJ regularly underlines that it will not tackle disparities between the laws of the Member States as this is the "harmonization task" of the European legislator. See Case C-157/07, Finanzamt für Körperschaften III in Berlin v. Krankenheim Ruhesitz am Wannsee-Seniorenheimstatt GmbH, 2008 E.C.R.____, ¶ 50, available at http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:62007J0157:EN:HTML.

[211] Unlike in its internal market case law, the ECJ, in its income tax case law (for example, in refusing access to Community law to group members with third country parents), reads neither a most-favored-nation obligation nor a prohibition of double taxation in the Treaty, and it accepts public interest justifications for tax discrimination.

[212] EC Treaty, note 4, arts. 2-4.

direct taxes.[213] In this regard it is astonishing that the finance ministries of the Member States have failed for twenty years to proactively investigate the EC compatibility of their tax laws and to make the necessary changes to avoid paying the price of any illegal imposition and collection of taxes.

On the other hand the criticism of the court for being too cautious by allowing a two-country approach instead of always applying a rigid one-country discrimination analysis,[214] though dogmatically correct, ignores the desirability of preventing taxpayers from deriving undue "double dip" tax advantages from their Community law rights. In this respect, the question of whether a contested measure of one Member State constitutes a discriminatory different treatment of similar domestic and cross-border situations should be distinguished from the question of whether perhaps the discriminatory effect of such a measure could be taken away by the effects of the other applicable tax system, notably as a result of the outcome of a bilaterally negotiated balanced allocation of tax jurisdiction (normally reflected in a tax treaty). In other words, whereas in establishing whether the contested measure is in principle EC incompatible, the court looks at the legal system of one Member State,[215] in establishing whether in the end the contested measure may be justified, it will look at the impact that the two tax systems that are involved in the cross-border situation at issue have on the position of the taxpayer.[216] This "post-discrimination analysis correction possibility" is balanced and to the advantage of the Member States, because, unlike in most other areas of law to which the prohibition of discrimination applies, it is possible to justify the discriminatory measure. In different forms the court followed this analysis in *Schumacker*,[217] *Marks & Spencer*,[218] and *Denkavit*.[219]

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213 The same Treaty provisions on free movement were accepted by all Member States with the ratification of, respectively, the 1957 Treaty of Rome, the 1987 Single European Act, the 1992 Maastricht Treaty, the 1997 Amsterdam Treaty, and the 2003 Nice Treaty, as well as with the signature of the 2005 Constitutional Treaty (abandoned) and the 2007 Lisbon Treaties (still in the process of ratification by all Member States). See sources cited in note 4.

214 See, e.g., Michael Lang, ECJ Case Law on Cross-Border Dividend Taxation: Recent Developments, 17 EC Tax Rev. 67 (2008). For an early discussion of this issue, see Axel Cordewener, Europäische Grundfreiheiten und nationales Steuerrecht 828 (2002).

215 See, e.g., Case C-170/05, Denkavit Internationaal BV v. Ministre de l'Économie, des Finances et de l'Industrie, 2006 E.C.R. I-11949, ¶ 18.

216 See, e.g., id. ¶ 42.

217 Case C-279/93, Finanzamt Köln-Alstadt v. Schumacker, 1995 E.C.R. I-225. Under a pure discrimination analysis a frontier worker always would be entitled to deductions in the work state because in a similar or competitive relation with his fellow workers.

218 Case C-446/03, Marks & Spencer plc v. Halsey, 2005 E.C.R. I-10837. Under a pure discrimination analysis Marks & Spencer would be allowed to compensate losses of foreign subsidiaries because UK law allowed this for domestic subsidiaries. See Income and Corporation Taxes Act, 1988, c. 4, § 402 (Eng.).

D. *Does the Court Cause Unacceptable Budgetary Burdens for the Member States?*

The criticism that the ECJ's decisions are very expensive and that they may even carry the more fundamental risk of affecting the powers of the Member States to decide their own socioeconomic model is exaggerated.[220] Starting with the second part, the underlying suggestion is that the ECJ's case law, by significantly limiting the capacity of the Member States to generate revenue, ultimately could affect the freedom of their democratically elected political governance structures to decide on expenditure levels and possibly even on budget allocations. Of course, the ECJ's case law has gone a long way to test the tax measures of the Member States against agreed and, therefore, self-imposed, constitutional margins, and this has significantly affected the way in which the Member States are allowed to tax intra-Community cross-border income flows. And indeed this may be annoying at times. But to suggest that the potential budgetary effect of the ECJ's case law is of such a magnitude that it could erode the tax bases of Member States to such an extent that they would have to change their fundamental choices with regard to their preferred socioeconomic model is disproportionate and unreal. To the author's knowledge, not even the Member States themselves have claimed this, though they have increasingly shown their concern over the potential budgetary effect of the ECJ's income tax case law, in particular, in relation to certain specific but highly publicized cases, such as the Italian IRAP[221] case, which concerned the compatibility of an indirect tax with the Sixth VAT Directive.[222]

Turning to the claim that the ECJ income tax case law is expensive, it is necessary to demystify certain arguments. First, an initial reality is that nobody, including the tax administration concerned, can indicate with any degree of reliability what the exact revenue consequences of a decision of the ECJ will be (see, for instance, the very different amounts stated by the parties in the *Meilicke* case).[223] A fur-

[219] *Denkavit*, 2006 E.C.R. I-11949. If domestic dividends remain untaxed (no withholding tax and exemption in the hands of the shareholder), the imposition of a withholding tax on outbound dividends is discriminatory if the nonresident shareholder also enjoys an exemption, but not if he enjoys a credit.

[220] This issue was discussed at the October 2005 Michigan Conference on Fiscal Federalism. See Comparative Fiscal Federalism, note 21.

[221] Case C-475/03, Banca Popolare di Cremona Soc. Coop. arl v. Agenzia Entrate Ufficio Cremona, 2006 E.C.R. I-9373.

[222] Council Directive 77/388/EEC, 1977 O.J. (L 145) 1.

[223] See Case C-292/04, Meilicke v. Finanzamt Bonn-Innenstadt, 2007 E.C.R. I-1835, ¶ 35 (Opinion of Advocate General Tizzano) (discussing how even the German government recognized that it had exaggerated its initial estimate of the costs). Advocate General Tizzano states

ther reality is that there is a tendency on the side of the tax administration to overstate the potential revenue losses caused by decisions of the ECJ.[224] As previously noted, rather than preventing the Member States from imposing income taxes, the ECJ merely tests the margins of the way in which taxes are imposed (on cross-border income flows), very much as any domestic constitutional court would test the constitutionality of any government action at the domestic level (without preventing the government from taking action). The ECJ, therefore, does not interfere with the level of taxation (or expenditure) in each Member State, nor consequently with the basic choice of socioeconomic model. Second, the cost of complying with a specific decision of the ECJ, even if it were sometimes running into more than EUR 100 million in a particular case, is small compared to the amounts of state aid that Member States choose to hand out annually (on average around EUR 70 billion a year of which approximately EUR 15 to 20 billion is in tax advantages).[225] Accordingly, on balance, the strict compliance of a domestic income tax system with EC law (constitu-

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> In the present case, the first condition could be said to have been met if the official figures supplied by the German Government are correct. It has estimated—and the estimate has not been challenged—that the refunds to be granted in the event of failure to limit the effect of a ruling of incompatibility would amount to EUR 9 to 13 billion (or 0.41% to 0.59% of the national GDP in 2004). It is true that that figure was reduced at the hearing to EUR 5 billion (or 0.25% of the GDP in 2004) in view of the fact that, as a result of changes in national tax procedures, unpaid tax credits can be claimed only in respect of dividends paid after 1998. Even so, it seems to me that the sums involved are considerable and are in any case such as to entail a "risk of serious economic repercussions."

224 Henk Vording & Allard Lubbers, How to Limit the Budgetary Impact of the European Court's Tax Decisions? (Leiden Univ., Dep't Econ. Research Memo. 2005.02, 2005), available at http://www.law.leidenuniv.nl/general/img/How%20to%20limit%20the%20budgetary%20impact%20of%20the%20European%20Courts%20tax%20decisons_tcm11-13005.pdf; see also Peter Gumbel, Taking the Taxman to Court, Time, Apr. 10, 2005, http://www.time.com/time/magazine/article/0,9171,1047314,00.html (reporting that the Dutch Government estimated the potential cost of the *Bosal* Decision at EUR 2 billion, and that the estimated cost for Germany of the *Marks & Spencer* decision would be EUR 30 billion (or around 1.5% of GDP)). Former German Finance Minister Hans Eichel claimed before the decision that his government could eventually have to repay up to EUR 50 billion ($60 billion) to German companies if the court ruled in favor of Marks & Spencer. See Marks & Spencer Gets 30 Million Pound Tax Rebate, Int'l Hearld Trib., Dec. 13, 2005, http://www.iht.com/articles/2005/12/13/business/web.1213eutax.php. This was clearly exaggerated because the German legislation on loss relief was not at all comparable with the U.K. legislation. See also note 223.

225 See European Comm'n, Competition: State Aid, http://ec.europa.eu/competition/state_aid/studies_reports/expenditure.html (last visited Mar. 1, 2009) (providing statistics on amounts of state aid and relative share of state aid instruments (for example, grants, tax exemptions, soft loans, and tax deferrals)). Total amount of aid varies from year to year and on a 10-year average hovers around EUR 70 billion a year. In the 2005-2007 period around EUR 19.5 billion of total state aid was disbursed in the form of tax exemptions and tax deferrals.

tional principles of free movement and rules on state aid) is likely to increase rather than decrease the funds available for government expenditure.

Moreover, an ex ante exercise by the Member States to ensure that their tax laws are Community compatible also can be undertaken in a revenue-neutral way and adjustments only result in costs if, in the absence of proactive domestic legislators, cases are lost in court. Such a systematic exercise seems long overdue.

Finally, in legal terms, the suggestion that the ECJ, when adjudicating income tax cases, should balance the interests of the Internal Market against the revenue interests of the Member States,[226] is not defendable. As already hinted at, unconstitutional behavior can never be justified by the argument that complying with the law would be too expensive. This is all the more so, as the Member States have all the domestic and Community regulatory powers at their disposal to ensure that income tax legislation and tax treaties comply with EC law.

E. *Is the Court's Direct Tax Case Law Inconsistent?*

The criticism that the ECJ's approach is inconsistent[227] (not only between its various decisions, which to a certain extent is inevitable for any supreme court that decides on a casuistic basis), in that it constitutes an inherently inconsistent attempt to assure an internal market in which capital import neutrality (CIN) and capital export neutrality (CEN) are realized simultaneously,[228] is based on a misunderstanding of the constitutional rules in the EU on the horizontal and vertical division of competences, which largely have been developed by the court itself. In fact the question of how to address discrimination, that is, neutrality within one tax system as regards domestic and cross-border activities, must be distinguished from the question of how to address disparities between two tax systems, including double taxation, that is, import neutrality (exemption) and export neutrality (credit).[229]

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226 See, e.g., Roman Seer, The ECJ on the Verge of a Member State Friendly Judicature?: Annotation to the *Marks & Spencer* Judgment, 3 Eur. Company & Fin. L. Rev. 237 (2006).

227 See, e.g., Joachim Lang & Joachim Englisch, A European Legal Tax Order Based on Ability to Pay, in International Tax Law 251 (Andrea Amatucci ed., 2007); Peter J. Wattel, Red Herrings in Direct Tax Cases Before the ECJ, 31 Legal Issues of Eur. Integration 81 (2004).

228 See Graetz & Warren, note 21, at 1220.

229 In fact, CIN and CEN concern matching the tax systems of the host and home state of a cross-border economic activity (and the related income flow) and avoiding double taxation, whether by means of a credit (CEN) or an exemption (CIN). With regard to the same cross-border income flow, exemption and credit are never applied simultaneously by the residence state and it is, therefore, widely held that CIN and CEN cannot be realized

The ECJ, however, does not rule on CIN and CEN in its income tax case law, but merely prohibits the tax system of one single Member State from discriminating against cross-border compared to domestic economic activity. The ECJ, therefore, enforces tax neutrality within one tax system between domestic and cross-border activity. With regard to CIN and CEN, the court has explicitly clarified that the Member States are free to allocate tax jurisdiction between them and to match two tax systems by either applying the credit or exemption method to avoid juridical double taxation.[230] Even if the ECJ would go one step further and declare the continued existence of double taxation unconstitutional (as it has done in many other areas of law),[231] this would not affect the freedom of the Member States to choose between the credit or exemption method.[232]

F. *Is the Court's Direct Tax Case Law Unintelligibly Complex?*

The criticism that the court's case law would be "woefully complex"[233] is exaggerated. Yes of course individual decisions are not always easy to read. Nor are clusters of decisions always immediately reconcilable. But in general terms one cannot possibly defend the notion that the broad lines in the case law of the court are unclear. On the contrary, as illustrated in this Article, there are, after twenty years of case law, a number of solid lines of case law on the general questions of the applicability of Community law to tax cases, the prohibition of discriminatory exit restrictions imposed by the home state as well as discriminatory access restrictions imposed by the host state, and the possibility of justifying national restrictive measures because of an overriding public interest.

It is, in fact, my conviction that the decisions of the court become complex and difficult to understand whenever the court in its tax decisions seeks to escape from the consequences of applying the internal market principles that it developed in its broader case law.

That is why decisions that exclude certain situations from the application of Community law, such as *Daily Mail*,[234] *Werner*,[235] and *Thin*

simultaneously (at least not by the residence state alone). See generally R.A. Musgrave, Criteria for Foreign Tax Credit, reprinted in Taxation and Operations Abroad 83-93 (Tax Inst. ed., 1960).

230 See, e.g., Case C-336/96, Gilly v. Directeur des Services Fiscaux du Bas-Rhin, 1998 E.C.R. I-2793.

231 See notes 38-41.

232 See van Thiel, The Future, note 44.

233 Hellerstein et al., note 109, at 118.

234 Case 81/87, The Queen v. H.M. Treasury, ex parte Daily Mail, 1988 E.C.R. I-5483.

235 Case C-112/91, Werner v. Finanzamt Aachen-Innenstadt, 1993 E.C.R. I-429.

Capitalisation Test Claimants,[236] can only be qualified as emergency brakes used by a court that is uneasy over intervening in politically sensitive discussions that take place at the level of the Member States. But emergency brakes are what they are: temporary interruptions of the train moving forward, and inevitably these decisions are, or will be, corrected so as to ensure that the direct tax case law is consistent with the broader internal market case law.

The same happened in the area of prohibited exit restrictions, where after incomprehensible decisions in *Daily Mail*, and *Werner*, the court went ahead in the tax area as it would have done in any other area of the law.[237]

G. *What About the Member States?*

In fact, Member States should be prudent in criticizing the ECJ for being too hard on their income tax systems. In fact, the court has gone out of its way to be flexible and forthcoming to Member States in the income tax area, and during the twenty years of income tax case law many traditional "internal market" case law rules have been bent:

(1) The court has been ready to invoke safety valves and emergency brakes, even though this almost always has caused a conceptual confusion and an inconsistency with previous case law.[238] In a more recent line it has gone far beyond sound legal reasoning, so as to limit access by third country multinationals to Community law benefits.[239]

(2) The court has limited itself to investigating whether contested tax measures constitute discrimination, and it has consistently avoided applying an MFN or restriction-based reading of the EC Treaty in its income tax case law, thus in effect placing tax treaties above the law.[240]

(3) The court has in its discrimination analysis applied a two-country approach to accommodate Member States, and to open the way to an investigation whether the discriminatory effect of a tax measure of one Member State was perhaps taken away by the tax measures of another Member State.[241]

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236 Case C-524/04, Test Claimants in the Thin Cap Group Litig. v. Commissioners of Inland Revenue, 2007 E.C.R. I-2107.

237 See, e.g., Case C-264/96, Imperial Chem. Indus. plc v. Colmer, 1998 E.C.R. I-4695.

238 See, e.g., *Daily Mail*, 1988 E.C.R. I-5483; *Werner*, 1993 E.C.R. I-429.

239 See *Thin Cap Test Claimants*, 2007 E.C.R. I-2107.

240 See note 37 and accompanying text.

241 See, e.g., Case C-379/05, Amurta SGPS v. Inspecteur van de Belastingdienst/Amsterdam, 2007 E.C.R. I-9569; Case C-446/03, Marks & Spencer plc v. Halsey, 2005 E.C.R. I-10837; Case C-170/05, Denkavit Internationaal BV v. Ministre de l'Économie, des Finances et de l'Industrie, 2006 E.C.R. I-11949; Case C-279/93, Finanzamt Köln-Alstadt v. Schumacker, 1995 E.C.R. I-225.

(4) The court sometimes has found dissimilarity on dubious grounds,[242] or implicitly accepted a de minimis disadvantage rule.[243]

(5) The court has investigated practically all public interest justifications argued by Member States,[244] in spite of the fact that most income tax cases concern discrimination, which under the traditional approach can be justified only on grounds explicitly mentioned in the EC Treaty.[245] In this new and more flexible approach towards Member States, the court sometimes has invented completely new grounds for justification, such as the need to maintain the coherence of the tax system,[246] which, however, had no basis in European law (nor in national law for that matter) and which, unsurprisingly perhaps, had to be significantly limited upon closer scrutiny.[247]

(6) The court has gone a long way in trying to accommodate Member States' traditional approaches toward tax avoidance and towards their own preferences as to how to shape inter-jurisdictional equity.[248] It developed an anti-avoidance doctrine that does allow Member States, on a case by case basis, to deny Community benefits to taxpayers who try to use wholly artificial constructions without economic substance to obtain undue tax advantages, an approach that is broadly parallel to the basic anti-avoidance rules in all Member States. In doing so it has deserted its own more principled decision that there is no such justification ground mentioned in the Treaty,[249] and, in a step by step approach, it has developed a European anti-avoidance concept that should be a reliable and effective tool in the hands of Member States to be used under the supervision of their own courts, without unduly burdening the internal market.

(7) The ECJ also has fully respected the way in which Member States allocate tax jurisdiction between them by means of tax treaties.[250]

In fact the court must be careful not to go too far. In particular in its approach to tax treaties, there are now a number of decisions in

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242 Case C-376/03, D. v. Inspecteur van de Belastingdienst, 2005 E.C.R. I-5821; Case C-8/04, Bujura v. Inspecteur van de Belastingdienst Limburg, 2004 O.J. (C 59) 17, subsequently removed from register by Order of the President of the Fourth Chamber of the Court of Justice of the European Communities, 2006 O.J. (C 60) 32.

243 Case C-446/04, Test Claimants in the FII Group Litig. v. Commissioners of Inland Revenue, 2006 E.C.R. I-11753.

244 See discussion in Section IV.A.

245 See, e.g., Case 270/83, Commission v. France (*Avoir Fiscal*), 1986 E.C.R. 273, ¶¶ 24-26.

246 See Case C-204/90, Bachmann v. Belgium, 1992 E.C.R. I-249, ¶ 28.

247 See notes 146-47 and accompanying text.

248 See discussion in Section IV.C.

249 *Avoir Fiscal*, 1986 E.C.R. 273, ¶ 25.

250 See, e.g., Case 336/96, Gilly v. Directeur des Services Fiscaux du Bas-Rhin, 1998 E.C.R. I-2793.

which the court, without any sound motivation, seems to be replacing its traditional individual rights-based perspective (taxpayer equity) with an almost blind acceptance of what Member States may wish to agree bilaterally (inter-jurisdictional equity).[251] And especially in these cases the price to be paid, in terms of conceptual confusion, disrespect for the basics of Community law, and potential distortions to the internal market, is simply too high.

Judging from the past, the reality in Europe seems to be that future developments in the area of European taxation can be expected to arise mostly from "negative integration" measures (in the areas where the Community executive and judiciary are active) and not so much from "positive integration" measures.[252]

Perhaps this will be true. But one cannot say that this is the fault of an over-active judiciary that is eager to take tax policy decisions and usurp the competencies of the Community and national legislators. It is an unavoidable consequence of the fact that the private sector necessarily has a key role in any process of integration of mixed economies, and the fact that both the Community legislator and the national legislators of the Member States, in the income tax area, have failed to carry out the tasks that they have constitutionally been allotted.

As noted above, if Member States want to, they can constructively retake the initiative, either by proactively screening their own tax systems to ensure that they no longer apply tax measures that discriminate against cross-border situations, or by engaging in active discussions on the possibilities of tax coordination[253] or of harmonizing income tax rules. If they choose not to clean up their tax systems they should not be complaining when their own taxpayers ask them to refund illegally collected taxes, and thus to pay the price for that choice.

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[251] See, e.g., Case C-376/03, D. v. Inspecteur van de Belastingdienst, 2005 E.C.R. I-5821.

[252] In 50 years of integration only a few directives were adopted by the Council to harmonize direct taxes in the interest of the internal market (essentially as regards cross-border dividends, interest, and royalties, as well as cross-border mergers). Any future legislative action in the tax area is hampered by the need for unanimity and the openly hostile position on further tax harmonization of certain Member States.

[253] See Council Resolution of 2 December 2008 on Coordinating Exit Taxation, 2008 O.J. (C 323) 1.