

Constitutional Restraints on Corporate Tax Integration

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I. INTRODUCTION

Economic double taxation occurs when corporate income is taxed twice: once to the corporation that earns the income and again to its shareholders who receive the income in the form of dividends. Economic double taxation can arise within a single state,¹ or it can occur across two or more states when the corporation and its shareholders are taxable in different states. There is considerable controversy over the question whether economic double taxation should be eliminated.² Indeed, if there were universal agreement that economic

¹ Here, and throughout this Article, we use the term "state" generically to include both national states and subnational states.

² ALI, Federal Income Tax Project, *Integration of the Individual and Corporate Income Taxes, Reporter's Study of Corporate Tax Integration 1-2* (1993) [hereinafter ALI Integration Study].

double taxation was a good idea and every taxing state had rules reflecting that view, the problem this Article addresses would not exist. Corporate income would simply be taxed twice, regardless of whether the dividend payment crossed state lines.

Accordingly, the fundamental problem that lies at the heart of this Article is not economic double taxation as such, but selective relief from economic double taxation. States that relieve economic double taxation usually limit relief to dividends paid by a resident corporation to a resident shareholder (“domestic dividends”), which creates differential (and arguably discriminatory) burdens on dividends paid by a corporation resident in one state to a shareholder resident in another (“cross-border dividends”).³ We explore the problems raised by efforts to provide relief from economic double taxation within the context of the European Union and the United States, where overriding constitutional restraints designed to foster economic integration limit the states’ tax autonomy. Before embarking on this inquiry, however, we wish to be clear about what we do—and do not—seek to accomplish in this Article, how we believe the Article fits into this symposium, and how we intend to proceed.

First, we delineate the judicially articulated constitutional restraints on a state’s approach to corporate tax integration in the European Union and United States and thereby lay the groundwork for meaningful comparative analysis of those restraints, which we undertake on a preliminary basis. We fully understand that the latter undertaking is hazardous at best, because we are discussing discrete constitutional frameworks, dissimilar taxing regimes, different levels of government, and disparate factual contexts. To minimize the “lost-in-translation” problem,⁴ and to provide a framework for future work in this area, we have set out in some detail the underlying principles relating to taxation of cross-border dividends from an international perspective, the approaches to corporate tax integration in both the European Union and United States, and the constitutional jurisprudence bearing on taxation of cross-border dividends that has emerged under the respective systems.⁵

³ *Id.* at 170-71.

⁴ Cf. Walter Hellerstein & Charles E. McLure, Jr., *Lost in Translation: Contextual Considerations in Evaluating the Relevance of the U.S. Experience for the European Commission’s Company Tax Proposals*, 58 *Bull. Int’l Fisc. Doc.* 86 (2004) (discussing the problems inherent in comparing taxation in the federal system of states in the United States with the treaty-based community of nations in Europe).

⁵ We refer to the fundamental freedoms of the EC Treaty as constitutional norms, even though, strictly speaking, the EC Treaty is not a constitution. See Opinion 1/91, European Economic Area, 1991 E.C.R. I-6079, ¶ 1. We feel justified in using this terminology, not least because the ECJ views the EC Treaty as “the constitutional charter of a Community based on the rule of law.” *Id.*

Second, in undertaking our inquiry, we make no effort to provide an overarching or “unified theory” of how cross-border dividends should be taxed in common markets. Our more modest goal is to identify what we believe are important and instructive common themes in the respective responses of the ECJ and the U.S. courts to the constitutional issues raised by state efforts to provide for corporate tax integration within the framework of an economic union.

The Article proceeds as follows. Part II establishes the basic framework for taxation of cross-border dividends, elaborating briefly on the fundamental concepts of economic double taxation and juridical double taxation and on the various approaches to corporate tax integration. Part III distills the ECJ’s complex case law concerning selective relief of economic double taxation and places it into a simple and coherent framework for analysis. Part III also offers our critique of the emerging constitutional doctrine governing dividend taxation in Europe. Part IV describes the U.S. case law involving selective relief from economic double taxation at the subnational state level, and thereby lays the groundwork for our comparison of the U.S. and ECJ jurisprudence involving claims that such relief discriminates against or burdens cross-border trade. Part V provides a comparative analysis of the EU and U.S. case law. Part VI concludes.

II. TAXATION OF CROSS-BORDER DIVIDENDS⁶

This Article focuses on taxation of cross-border dividends under EU and U.S. constitutional law. In examining the issues raised by cross-border dividend taxation, we first provide an overview of the concepts of economic and juridical double taxation as well as the respective efforts by the EU and U.S. states to relieve economic double taxation by reducing or eliminating the tax on dividends. For purposes of this discussion, a cross-border dividend is “outbound” from the perspective of the corporation’s state of residence, because the dividend flows to a taxpayer in another state; a cross-border dividend is “inbound” from the perspective of the shareholder’s state of residence, because the dividend flows to a taxpayer within the state.

A. *Economic Double Taxation*

Economic double taxation occurs when the same item of income is taxed to two different taxpayers. Corporate profits suffer economic double taxation if they are taxed to the corporation when earned and

⁶ The discussion in the first three Sections, while couched as a generic consideration of “states” (whether national or subnational), is concerned essentially with principles developed under international tax law.

a second time when distributed to its individual or corporate shareholders. To prevent “cascading” corporate-level taxes on intercorporate dividend distributions in a domestic setting, almost all states employ corporate-level economic double tax relief mechanisms, the most prevalent being dividend exemption, the dividends-received deduction, and group relief.⁷ Relief from cascading corporate taxes accommodates modern corporate structures, which often involve several tiers of corporations.

Although states usually provide economic double tax relief to corporate shareholders, practices diverge when the shareholder is a natural person. Some states operate so-called “classical” tax systems, which intentionally impose economic double taxation on corporate profits.⁸ In these systems, the corporation pays tax on its profits, and, when it distributes those post-tax profits to its individual shareholders in the form of dividends, the shareholders also pay tax on the dividends.⁹

States without classical systems employ a variety of methods to relieve economic double taxation by “integrating” the corporate- and shareholder-level taxes.¹⁰ Integration addresses a number of perceived defects of the classical system.¹¹ First, because investments in corporations are taxed less favorably than investments in nontaxable business entities under a classical system,¹² the choice of the form of investment may be distorted.¹³ Investors who would conduct business in the corporate form absent tax considerations instead may choose a less desirable business form to avoid the second layer of tax on business profits.¹⁴

Second, a classical tax regime creates a bias in favor of debt over new equity financing because interest payments, but not dividend distributions, are deductible from the taxable income of the corporation.¹⁵ This is undesirable because it may increase the risk of corporate bankruptcy and increase the cost of borrowing.

⁷ Robert J. Staffaroni, *Size Matters: Section 367(a) and Acquisitions of U.S. Corporations by Foreign Corporations*, 52 *Tax Law.* 523, 523-24 (1999).

⁸ ALI Integration Study, note 2, at 1.

⁹ *Id.*

¹⁰ See generally Treasury Dep’t, *Report on Integration of the Individual and Corporate Tax Systems: Taxing Business Income Once* (1992) [hereinafter Treasury Integration Report]; ALI Integration Study, note 2; Charles E. McLure, Jr., *Must Corporate Income Be Taxed Twice?* (1979).

¹¹ See ALI Integration Study, note 2, at 21-46; Treasury Integration Report, note 10.

¹² ALI Integration Study, note 2, at 22-23.

¹³ Treasury Integration Report, note 10, at 24.

¹⁴ *Id.*

¹⁵ ALI Integration Study, note 2, at 28. This discussion assumes that the shareholder/debtholder is itself a taxable party. The bias is in favor of debt financing since under cer-

Third, the desire to defer the shareholder-level tax may lead the corporation to retain earnings, even in cases where the shareholder could employ the distributed earnings in more productive investments than those available to the corporation.¹⁶ Finally, taxing corporate profits twice creates an incentive for companies to distribute their profits in forms other than dividends, such as tax-free redemptions, and to disguise dividends as a form of payment that is deductible to the corporation, such as salary.¹⁷ Thus, economic double taxation distorts the form of the investment, including whether business is conducted through corporate or noncorporate business entities, the capitalization of the company by debt or equity, and the timing and character of profits distributions.

Despite the distortions caused by economic double taxation, there is no international consensus that it should be eliminated.¹⁸ The United States moved from an integrated corporate tax in the period before 1938 to a classical system for the remainder of the twentieth century.¹⁹ Since 2003, the United States has operated a partial integration system under which corporate profits are fully taxable, but dividends are taxed to the shareholder at a preferential rate, rather than the shareholder's marginal tax rate.²⁰ In contrast with the long adherence to a classical system in the United States, beginning in the 1950's most of the European states introduced integration.²¹

A state that intends to eliminate the distortions caused by economic double taxation of corporate profits has available a number of possible integration mechanisms. Reflecting the policy choices of the EU and U.S. states, we limit our discussion to distribution-related integration methods, including shareholder imputation, dividend deduction, dividend exclusion, and the schedular method.²² In contrast with

tain conditions it would be more tax efficient for the corporation to make investments with debt financing than with new equity financing. *Id.* at 25-28.

¹⁶ Treasury Integration Report, note 10, at 37.

¹⁷ *Id.*; ALI Integration Study, note 2, at 39-41.

¹⁸ For arguments favoring eliminating the corporate double tax, see ALI Integration Study, note 2, and Treasury Integration Report, note 10. But see Reuven Avi-Yonah, Corporations, Society, and the State: A Defense of the Corporate Tax, 90 *Va. L. Rev.* 1193 (2004) (arguing for a separate tax on corporate income in addition to the tax on dividend income).

¹⁹ Yariv Brauner, Integration in an Integrating World, 2 *N.Y.U. J.L. & Bus.* 51, 53 n.12 (2005).

²⁰ Jobs and Growth Tax Relief and Reconciliation Act of 2003, tit. III, sec. 301, § 1(h)(B), 117 Stat. 752, 758 (scheduled to expire in 2010).

²¹ See Brauner, note 19, at 68-76. (noting that Germany enacted an imputation system in 1953, France in 1965, Britain in 1972, and Italy in 1977).

²² Other methods include: (1) the split-rate system used by Germany from the 1950's to the late 1970's, under which retained earnings were taxed to the corporation at a higher rate than that imposed on distributed earnings, (2) shareholder allocation, (3) mark-to-market, under which the corporate tax is repealed and shareholders are taxed currently on

“full” integration, which would tax all the income of the corporation currently to its shareholders on a pass-through basis, shareholder-level integration methods are considered to be “partial” integration because they maintain a nominal distinction between the corporate and shareholder level taxes.²³

B. Juridical Double Taxation

In contrast to economic double taxation, which may occur in domestic and cross-border contexts, juridical double taxation occurs only in cross-border contexts,²⁴ when the same person is taxed on the same item of income by two different states. It arises because states’ jurisdiction to tax cross-border income overlaps. International law recognizes two jurisdictional bases for taxation: source and residence. The source state, where income is earned, has a right to tax, and the residence state, where the owner of the income resides, also has a right to tax, although in some cases the resident state’s tax right is considered to be secondary to the source state’s right.²⁵ When the source and residence states both exercise their jurisdiction to tax cross-border income in the same taxable period, juridical double taxation results.²⁶

Corporate profits paid out as cross-border dividends may be subject to both economic and juridical double taxation because there are both source-based and residence-based predicates for taxation at both the corporate and shareholder level. Accordingly, there are four theoretical predicates for taxation of the same income. First, the state in which the corporation earns its income may tax its profits on a source basis. Second, the corporation’s residence state may tax the same corporate-level income on a residence basis. Third, the corporation’s residence state may tax the dividends distributed to shareholders on a source basis because dividends ordinarily are sourced according to the

the change in value of their shares, (4) corporate-level expensing of capital investments, which is equivalent to exempting the return on the investment, and (5) comprehensive business income taxation (CBIT), which taxes all forms of business investment (including debt) only once, at the entity’s tax rate. See ALI Integration Study, note 2, at 47-113 (advocating imputation as the best method of integration for the United States); Treasury Integration Report, note 10, at 190 (declining to recommend that the United States move to an imputation system).

²³ Emil M. Sunley, *Corporate Integration: An Economic Perspective*, 47 Tax L. Rev. 621, 624 (1992).

²⁴ OECD, *Model Convention with Respect to Taxes on Income and on Capital*, July 17, 2008, Introduction, ¶ 1, available at <http://www.oecd.org/dataoecd/34/0/42034520.pdf>. [hereinafter OECD Model Treaty].

²⁵ ALI Integration Study, note 2, at 170-71.

²⁶ See OECD Model Treaty, note 24, Introduction, ¶ 1.

state of residence of the distributing corporation.²⁷ When the shareholder resides in another state, the corporation's state ordinarily collects the dividend tax by means of withholding.²⁸ Fourth, the shareholder's residence state also may tax the shareholder on the receipt of the dividend under the residence principle of taxation. As a simplifying assumption, for the remainder of this Article we assume that the corporation's profits have their source in its state of residence, which means we discuss only three taxes: (1) the corporate-level tax assessed by the corporation's residence state (the "corporation's state"), (2) the shareholder-level tax collected through withholding by the corporation's state, and (3) the shareholder-level tax collected by the shareholder's residence state (the "shareholder's state").

A single cross-border dividend may be subject to both juridical and economic double taxation. For example, suppose a U.S. corporation pays a dividend to a Canadian shareholder. As the corporation's state, the United States would tax the corporation's profits, and as the source of the dividend, it also would tax the Canadian shareholder on the dividend by means of withholding. Additionally, Canada, as the shareholder's residence state, would tax the shareholder on the dividend. This case involves juridical double taxation—two states tax the Canadian shareholder on the dividend. It also involves economic multiple (triple) taxation, since the same corporate profits are taxed to both the corporation and the shareholder by the United States, and again to the shareholder by Canada.

There is widespread agreement among states that juridical double taxation leads to inefficient distortions of international investment flows, and the existence of several thousand bilateral tax treaties aimed at reducing or eliminating juridical double taxation testifies to the consensus that juridical double taxation should be avoided.²⁹ In contrast, the question of whether, and to what extent, economic double (or multiple) taxation should be relieved remains controversial. Notably, the rules for taxing cross-border dividends contained in the OECD Model Treaty—which allow both the source state (the corporation's state) and the residence state (the shareholder's state) to tax the shareholder on a cross-border dividend—were developed at time when classical taxation of dividends was the norm.³⁰ The entitlement of the source state to withhold tax on the outbound dividend

²⁷ See, e.g., IRC § 861(a)(2)(A) (sourcing dividends to corporate payor's state of residence).

²⁸ ALI Integration Study, note 2, at 170.

²⁹ See OECD Model Treaty, note 24, Introduction, ¶¶ 14-15.

³⁰ Hugh J. Ault, *Corporate Integration, Tax Treaties and the Division of the International Tax Base*, 47 Tax L. Rev. 565, 569 (1992).

reflects the expectation that corporate profits will be taxed separately to the corporation and the shareholder.³¹ The incidence of the withholding tax is meant to fall on the foreign shareholder: It parallels the requirement that domestic shareholders include the dividend in income. Arguably, in cases where the state relieves economic double taxation for domestic dividends, assessing withholding taxes on out-bound dividends would not be appropriate, because the withholding tax represents a second “layer” of tax on corporate profits.³² As discussed in the next Section, however, states often relieve economic double taxation on domestic, but not cross-border, dividends.

C. *Double Taxation of Cross-Border Dividends*

States that relieve economic double taxation on domestic dividends generally do not extend relief to cross-border dividends, and only a very few states do so pursuant to bilateral tax treaties.³³ Several strategic reasons explain the limitation of economic double tax relief to domestic dividends. First, unilateral extension of double tax relief is costly: By extending relief to cross-border dividends, a state forgoes revenue.³⁴ Second, even if the source state waived its withholding tax on the dividend,³⁵ to relieve economic double taxation of the underlying corporate profits, one of the two states—either the company’s state or the shareholder’s state—would have to forgo collecting tax.³⁶ But states may have different views as to which state should forgo collecting tax.³⁷ Additionally, by refusing to extend benefits unilater-

³¹ *Id.* at 566.

³² Ault argues that under integration, it would be “difficult (and illogical) to apply the traditional rules of international taxing jurisdiction as developed in treaties.” *Id.*

³³ See *id.* at 579, 585-86 (noting that in an effort to attract foreign investment, France became the first country unilaterally to extend shareholder imputation credits to nonresidents with portfolio investments in French companies and noting that few countries extend economic double tax relief to cross-border direct investment).

³⁴ OECD Model Treaty, note 24, art. 10, cmt. 54.

³⁵ This assumption is not fanciful. Some countries agree to waive withholding taxes on direct intercorporate dividends via double tax treaties. See, e.g., Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, U.S.-Japan, art. 10, Nov. 6, 2003, 3 Tax Treaties (CCH) ¶ 5201.10. Even in cases where the source state withholds, the residence state may fully credit the withholding under its tax treaty. See *id.* at art. 23, 3 Tax Treaties (CCH) ¶ 5201.23.

³⁶ In the alternative, the source and residence states could agree to somehow split the single tax on corporate income. The result would be that states would assess less tax on corporate profits flowing across the border, but since both states would tax, the aggregate tax would approximate the tax applicable in the purely domestic context.

³⁷ See OECD Model Treaty, note 24, art. 24, cmt. 30; ALI Integration Study, note 2, at 188; Sunley, note 23, at 630 (noting that net capital importers and net capital exporters will have different views on this matter).

ally, states may hope to negotiate for reciprocal economic double tax relief obligations in tax treaties.³⁸

Furthermore, other practical considerations may pose an obstacle to extending economic double tax relief to cross-border dividends. The amount of relief a state offers in the domestic context depends on the corporate and individual tax rates and the desired degree of integration. In the international tax context, because different states assess the shareholder-level and the corporate-level taxes, the economic double tax relief offered by a particular state will not be coordinated with the overall tax assessed on the distributed corporate profits by both states.³⁹ Disparities in the tax systems of the source and residence state may result in too much or too little economic double tax relief.⁴⁰

As noted, the guidelines for allocating jurisdiction to tax cross-border dividends developed at a time when economic double taxation of corporate profits was the norm,⁴¹ and these guidelines were not revised despite many states' adoption of corporate tax integration in the mid-twentieth century.⁴² The retention of source state withholding taxes despite elimination of economic double taxation on domestic dividends is incongruous.⁴³ If no tax will be collected at the domestic shareholder level because of integration, why levy withholding on foreign shareholders?

The OECD Model Treaty contains a nondiscrimination article, which provides that in certain specified cases a contracting state will not treat the nationals of its treaty partner or inbound investments worse than its own similarly situated nationals or domestic investments.⁴⁴ Some countries have argued (outside the common market context) that source states discriminate if they do not extend domestic

³⁸ But see Ault, note 30, at 585 (noting that countries may refuse to grant imputation credits on a reciprocal basis, since that might encourage too much outward portfolio investment).

³⁹ See ALI Integration Study, note 2, at 170-71 (discussing division of jurisdiction and attempts to coordinate the tax result through bilateral treaties).

⁴⁰ See *id.*

⁴¹ Some observers regard these rules as obsolete. See, e.g., Ault, note 30, at 566 ("[T]here seems to be increasing recognition that the solutions developed in the past are not adequate for an increasingly interdependent world of international trade and investment."). Tax treaties have not changed dramatically since Ault made this observation in 1992.

⁴² For the history of adoption of integrated tax systems, with emphasis on European and Anglo-American countries, see Brauner, note 19.

⁴³ ALI Integration Study, note 2, at 175 (calling withholding taxes "artifacts of a classical double tax in that they are intended to collect from foreign investors an amount roughly equivalent to what would be collected from domestic shareholders under the personal income tax").

⁴⁴ OECD Model Treaty, note 24, art. 24.

economic double tax relief to foreign investors.⁴⁵ For example, even when the United States operated a fully classical double tax system, it had some success convincing its tax treaty partners to extend shareholder imputation credits to U.S. shareholders on the grounds that failure to grant imputation credits on outbound dividends would be discriminatory.⁴⁶

In cases where the negotiating countries reach no agreement concerning the obligation to grant economic double tax relief on cross-border dividends, the OECD nondiscrimination article does not appear to compel the granting of such relief, and the OECD Model Treaty and its Commentary expressly provide that both countries may tax dividends.⁴⁷ Countries usually justify their refusal to extend economic double taxation relief to cross-border dividends by citing revenue concerns,⁴⁸ or by arguing that the treaty partner ought to be the one to grant the relief.⁴⁹ In light of the conflicting views held by the OECD Members, the OECD Model Treaty does not contain specific language concerning economic double tax relief on cross-border dividends, and the OECD urges negotiating countries to make their intentions clear in their particular treaty.⁵⁰ In sum, the narrow international tax conception of nondiscrimination as embodied in the OECD Model Treaty does not appear to impose material constraints on states' ability to provide selective relief from economic double taxation. Consequently, sovereign states remain free to approach the question of corporate tax integration on a parochial basis without regard to the consequences of those rules for cross-border trade.

⁴⁵ ALI Integration Study, note 2, at 173.

⁴⁶ *Id.* at 173 (citing the treaties between the United States and France, Germany, and the United Kingdom); see also Ault, note 30, at 583-84 (discussing the 1965 U.S.-German tax treaty negotiations as they related to the integration issue).

⁴⁷ OECD Model Treaty, note 24, arts. 10, 24; art 10., cmts. 4-8. Comment 6 to Article 10 also notes that taxation exclusively by the shareholder's residence state would comport with the notion of dividends as investment income, but "it would be unrealistic to suppose that there is any prospect of it being agreed that all taxation of dividends at the source should be relinquished." *Id.* art. 10, cmt. 6.

⁴⁸ *Id.* art. 10, cmt. 54 ("[T]he State concerned would thereby be making a unilateral budgetary sacrifice . . .").

⁴⁹ This argument is advanced in the permanent establishment context. See *id.* art. 10, cmt. 31.

⁵⁰ See, e.g., *id.* art. 10, cmts. 51-56 (suggesting as one possibility that the source state forgo withholding and the residence state allow against the shareholder-level tax whatever relief it normally provides on domestic dividends, in lieu of a credit for the source country's withholding tax); see also *id.* art. 10, cmt. 62 (noting that "no generally accepted principles have emerged" for how to relieve economic double taxation on cross-border intercompany dividends).

D. EU Legislative Deviations from International Dividend Taxation

Our description of international taxation of cross-border dividends generally applies to EU Member States because they remain separate sovereign countries with full tax powers, except insofar as the EC Treaty⁵¹ or implementing Community law limits these powers. Because the EC Treaty conferred no express power to tax upon the European Community, the Member States remain the principal taxing authorities.⁵² Member States, however, may not levy taxes in violation of EC law, including the EC Treaty's prohibition of discrimination enshrined in its fundamental freedoms,⁵³ a limitation that we explore more fully in Part III. This Section concerns the EC legislature's efforts to pass EU-wide legislation for the relief of economic double taxation.

Subject to constitutional limitations contained in the EC Treaty, Member States remain virtually unconstrained in how they tax corporate profits, and methods vary throughout the European Union.⁵⁴ While some states completely integrate their corporate and shareholder-level taxes, others embrace full economic double taxation.⁵⁵ Within the European Union, failure to relieve economic double taxation creates the same kinds of distortions already discussed.⁵⁶ These distortions have EU-wide implications⁵⁷: By discouraging distribution of profits, economic double taxation hampers the development of the European capital market by reducing available capital. Additionally, investments through retained earnings may yield lower (before-tax) returns than can be obtained elsewhere, leading to an inefficient allocation of resources across Europe. Finally, economic double taxation creates a bias in favor of pre-existing firms funded by retained earnings, which inhibits the entry of new firms, thereby jeopardizing the efficiency of the internal market.⁵⁸

⁵¹ Consolidated Version of the Treaty Establishing the European Community, Dec. 29, 2006, 2006 O.J. (C 321E) 37 [hereinafter EC Treaty].

⁵² Id. arts. 90-93 (containing all of the tax provisions of the EC Treaty, but not providing the EC with power to tax and explicitly stating that Member States continue to exercise taxing authority).

⁵³ Id. art. 12.

⁵⁴ See Joann Martens Weiner, *Practical Aspects of Implementing Formulary Apportionment in the European Union*, 8 Fla. Tax Rev. 629, 632-33 (2007).

⁵⁵ Cyprus, Greece, Estonia, Latvia, and Slovakia fully exempt dividends from tax at the shareholder level, whereas Ireland and Romania have fully classical systems. See discussion in Section III.D.

⁵⁶ See Section II.A.

⁵⁷ See Sijbren Cnossen, *Company Taxes in the European Union: Criteria and Options for Reform*, *Fiscal Stud.*, Nov. 1996, at 67, 72-73.

⁵⁸ Id.

To combat these distortions, many EU Member States offer some measure of economic double tax relief.⁵⁹ States offering relief on domestic dividends have not been immune, however, from the revenue pressure to exclude cross-border dividends from relief.⁶⁰ Thus, until a recent spate of cross-border dividend cases in the European Court of Justice (ECJ), most EU states taxed domestic and cross-border dividends differently.⁶¹ Wholly apart from distortions of the form of corporate investment caused by economic double taxation, limitation of economic double tax relief to domestic dividends may distort where taxpayers invest their capital. Such locational distortions are a special concern in the European Union because they tend to undermine the goal of economic integration.⁶²

Tax policymakers in the European Union have long recognized that exclusion of cross-border dividends from domestic economic double tax relief tends to “fragment capital markets in the Community.”⁶³ The Commission thus supports EU-wide corporate integration to promote the competitiveness of EU financial markets, market liquidity, efficient allocation of capital, and choice for investors.⁶⁴ To address the problem of selective double tax relief, serious proposals for EU-wide corporate integration were made as early as 1962,⁶⁵ and continuously thereafter.⁶⁶ The history of legislative attempts at integration,

⁵⁹ *Id.* at 69-72.

⁶⁰ OECD Model Treaty, note 24, art. 10, cmts. 5-7.

⁶¹ See Weiner, note 51, at 633-39 (2007) (discussing such ECJ decisions and their impact on tax reform).

⁶² See *id.* at 635.

⁶³ Commission of the European Communities, Report of the Committee of Independent Experts on Company Taxation 207 (1992) [hereinafter Ruding Report] (concluding also that different relief for domestic and cross-border dividends was discriminatory).

⁶⁴ See Communication from the Commission to the Council, the European Parliament and the European Economic and Social Committee, Dividend Taxation of Individuals in the Internal Market 2, COM (2003) 810 final (Dec. 19, 2003) [hereinafter Communication on Dividend Taxation].

⁶⁵ See EEC Comm'n, Fiscal & Fin. Comm., Report on Tax Harmonization in the Common Market (Neumark Report) (July 8, 1962), reprinted in the EEC Reports on Tax Harmonization: The Report of the Fiscal and Financial Committee and the Reports of the Subgroups A, B, and C, at 93-203 (H. Thurston trans., 1963).

⁶⁶ Proposal for a Council Directive on the Common System of Taxation Applicable to Parent Companies and Their Subsidiaries of Different Member States, COM (1969) 6 final (Mar. 22, 1969) (advocating gradual harmonization of direct taxation throughout the original six-country Community and advocating the split-rate system of corporate tax integration, under which retained profits would be taxed at a higher rate than distributed profits); The Development of a European Capital Market (Report of a Group of Experts appointed by the EEC Commission) 299-302 (1966) (Segré Report) (criticizing the locational distortions created when Member States provided imputation credits for domestic but not cross-border dividends, and recommending extension of imputation credits by the corporation state to foreign shareholders); Commission's Memorandum on the “Tax Harmonisation Programme—Programme for the Harmonisation of Direct Taxes,” 8 Bull. Supp. 4 (1967) (stressing the necessity of a common method for double tax relief on dividends); A.J. van

including the great variety of approaches suggested by the European Commission over the years, reflects the general lack of consensus on whether and how economic double taxation of corporate profits should be eliminated.⁶⁷ Thus far, economic double taxation has been legislatively eliminated only on a portion of cross-border intercorporate dividends—those covered by the Parent-Subsidiary Directive—and even that legislation was not passed until 1990.⁶⁸

Implemented by the Member States by 1992, the Parent-Subsidiary Directive exempts from withholding tax intercorporate dividends and profit shares paid by a qualifying EU subsidiary to its qualifying EU parent corporation that owns at least 10% of its stock.⁶⁹ In addition to preventing the subsidiary's residence state from assessing withholding tax on the dividend, the Parent-Subsidiary Directive requires the parent corporation's residence state to avoid economic double taxation of the distributed profits, either by exempting the parent corporation from tax on the dividend or by providing the parent corporation an indirect tax credit for the corporate tax paid by its subsidiary to the subsidiary's state of residence.⁷⁰ Because the Parent-Subsidiary Directive forbids economic double tax on cross-border intercorporate dividends, the constitutional issue of selective relief of economic double taxation generally is limited to cases not covered by the Directive. Thus, the selective relief issue arises in two contexts: intercorporate portfolio dividends and dividends to individual shareholders.

den Tempel, *Corporation Tax and Individual Income Tax in the European Communities* (EEC Comm'n, Approximation of Legislation Series No. 15, 1970) (conceding that double taxation of corporate profits resulted in capital allocation distortions and market inefficiencies, but emphasizing reduction of locational distortions and ultimately recommending adoption of the classical system); *Proposal for a Council Directive concerning the harmonisation of systems of company taxation and of withholding taxes on dividends*, COM (1975) 392 final, 1975 O.J. (C 253) 2, reprinted in 10 Bull. Supp. (1975), and in 3 Intertax 215 (1975) (proposing (1) an EU-wide partial imputation system, (2) harmonization of Member State corporate tax rates to a band between 45% and 55%, and (3) harmonization of withholding tax rates on dividends at 25%).

⁶⁷ See generally Pamela A. Fuller, *The Japan-U.S. Income Tax Treaty: Signaling New Norms, Inspiring Reforms, or Just Tweaking Anachronisms in International Tax Policy?*, 40 Int'l Law. 773, 859-69 (discussing history of EC attempts at integration).

⁶⁸ Council Directive 90/435, *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].

⁶⁹ Id. The Commission steadfastly advocated for the Parent-Subsidiary Directive since an early version was proposed in the 1970's. See Commission Communication, *Action Programme for Taxation 7*, COM (1975) 391 final (July 23, 1975), reprinted in 3 Intertax 206, 209 (1975); Commission Communication, *Fiscal Measures Aimed at Encouraging Co-operation Between Undertakings of Different Member States 1*, COM (1985) 360 final (July 23, 1985); Commission Communication, *Guidelines on Company Taxation 7*, SEC (1990) 601 (Apr. 20, 1990), reprinted in 18 Intertax 487, 490 (1990).

⁷⁰ Parent-Subsidiary Directive, note 68, at 7.

Recently, the Commission has taken a two-pronged approach to dividend taxation. The focus of the first prong is legislative. The Commission has undertaken the Common Consolidated Corporate Tax Base project, which aims broadly at harmonizing the corporate tax bases of the Member States.⁷¹ The success of this project remains uncertain, and it seems highly unlikely that the Member States will soon agree on any form of legislative or “positive” harmonization of corporate-shareholder integration for portfolio dividends. The focus of the Commission’s second prong is judicial.⁷² The Commission evaluates domestic tax systems in the light of the EC Treaty’s fundamental freedoms and takes appropriate action by setting out its tax policy ideas,⁷³ informing Member States about its position,⁷⁴ proposing coordinated approaches,⁷⁵ and, when necessary, initiating infringement proceedings before the ECJ against Member States it believes to be in violation of the EC Treaty.⁷⁶ The Commission also generally submits its views to the ECJ in cases initiated by taxpayers in national courts and referred to the ECJ for preliminary ruling.⁷⁷ The Commission’s broadly stated view is that excluding intra-Community dividends from

⁷¹ See European Comm’n, Taxation & Customs Union, Common Tax Base, http://ec.europa.eu/taxation_customs/taxation/company_tax/common_tax_base/index_en.htm (last visited Mar. 1, 2009) (highlighting recent developments).

⁷² See Communication on Dividend Taxation, note 64, at 9-18; Opinion of the European Economic and Social Committee on the Communication from the Commission to the Council, the European Parliament and the European Economic and Social Committee: Dividend Taxation of Individuals in the Internal Market, 2004 O.J. (C 302) 70, 70-73.

⁷³ See Communication from the Commission to the Council, the European Parliament and the Economic and Social Committee: Tax Policy in the European Union—Priorities for the Years Ahead 15-18, COM (2001) 260 final (May 23, 2001) [hereinafter Communication on Priorities]; Communication from the Commission to the Council, the European Parliament and the Economic and Social Committee, Towards an Internal Market Without Tax Obstacles: A Strategy for Providing Companies with a Consolidated Corporate Tax Base for Their EU-Wide Activities at 10-21, COM (2001) 582 final (Oct. 23, 2001) [hereinafter Communication on Consolidated Corporate Tax Base]; Commission Staff Working Paper, Company Taxation in the Internal Market 306-423, SEC (2001) 1681 (Oct. 23, 2001), available at http://ec.europa.eu/int/comm/taxation_customs/resources/documents/company_tax_study_en.pdf [hereinafter Working Paper on Company Taxation].

⁷⁴ See Working Paper on Company Taxation, note 73, at 225-32; Communication on Dividend Taxation, note 64.

⁷⁵ See Communication from the Commission to the Council, the European Parliament and the European Economic and Social Committee, Co-ordinating Member States’ Direct Tax Systems in the Internal Market 1-8, COM (2006) 823 final (Dec. 19, 2006).

⁷⁶ For cases in which the Commission challenged national tax laws before the ECJ, see, for example, note 210.

⁷⁷ See, e.g., Case C-470/04, *N v. Inspecteur van de Belastingdienst Oost/kantoor Almelo*, 2006 E.C.R. I-7409; Case C-251/98, *Baars v. Inspecteur der Belastingdienst Particulieren/Ondernemingen Gorinchem*, 2000 E.C.R. I-2787.

economic double tax relief provided to domestic dividends violates the EC Treaty, irrespective of the form the relief takes.⁷⁸

Because the requirement of Council unanimity in tax matters⁷⁹ and the political controversy among the states about whether and how to integrate corporate and shareholder taxation have largely stymied legislative efforts to provide an EU-wide solution to the problem of economic double taxation, the ECJ has emerged as the major engine of corporate tax integration in Europe, and its jurisprudence addressed to this issue is the focus of the next Part.

III. EC LAW AND CORPORATE TAX INTEGRATION

The most important fundamental freedoms for dividend taxation are the freedom of capital movement, which protects cross-border portfolio dividends,⁸⁰ and the freedom of establishment, which protects cross-border direct dividends.⁸¹ Articles 56 and 58 of the EC Treaty provide for the free movement of capital, under which “all restrictions on the movement of capital between Member States and between Member States and third countries shall be prohibited.”⁸² Articles 43 and 48 of the EC Treaty provide for the freedom of establishment, under which EU nationals have the right to establish business activities across Member State borders.⁸³ The freedom of establishment applies to direct investment, judicially defined to include cases where the shareholder’s stake in the company is sufficient to give him “definite influence over the company’s decisions and allows him to determine its activities.”⁸⁴ While the ECJ has not set a precise threshold of stock ownership that will constitute a “definite influence,” it has found such influence in holdings from 100% to

⁷⁸ Working Paper on Company Taxation, note 73, at 307-16. The Commission also considers Member States to be in violation of EC law if they impose cumbersome administrative requirements on taxpayers seeking double tax relief on intra-Community dividends. See id. at 312; 2003 Communication on Dividend Taxation of Individuals, note 64 (discussing different dividend taxation systems).

⁷⁹ See EC Treaty, note 51, art. 93.

⁸⁰ Although the EC Treaty does not define “capital movement,” see EC Treaty, note 51, art. 56, the ECJ has ruled that the receipt of an intra-Community dividend is covered by the freedom of capital movement. See, e.g., Case C-35/98, *Staatsecretaris van Financiën v. Verkooijen*, 2000 E.C.R. I-4071, ¶¶ 28-30.

⁸¹ See, e.g., *Baars*, 2000 E.C.R. I-2787, ¶¶ 21-22 (discussing freedom of establishment in the context of dividend taxation).

⁸² EC Treaty, note 51, art. 56(1).

⁸³ Id. art. 43 (EU nationals have “the right to take up and pursue activities as self-employed persons and to set up and manage undertakings, in particular companies or firms . . . under the conditions laid down for its own nationals by the law of the country where such establishment is effected.”).

⁸⁴ *Baars*, 2000 E.C.R. I-2787, ¶ 22.

50%,⁸⁵ and it has suggested that under certain circumstances “definite influence” could be inferred from a holding of 25% or less.⁸⁶ In contrast, a 10% holding usually will not suffice.⁸⁷

In cases falling below the “definite influence” threshold, the freedom of capital movement applies. Although the nature of the protection provided under each freedom seems to be the same, its scope differs because the freedom of capital movement also applies to the movement of capital “between Member States and third countries,”⁸⁸ whereas the freedom of establishment applies only within the Union’s borders.⁸⁹ The ECJ has begun to consider the applicability of the freedom of capital movement in third country tax cases only recently, and, thus far, the court has strained to avoid deciding cases under the freedom of capital movement, presumably in an effort to limit the third country effects of the EC Treaty.⁹⁰

The freedoms of establishment and capital movement partially overlap with the Parent-Subsidiary Directive, which prohibits both economic and juridical double taxation of dividends paid by a subsidiary established in an EU Member State to a parent corporation established in a different Member State that owns at least 10% of the stock of the subsidiary.⁹¹ Of course, the existence of secondary EC law concerning dividends does not narrow the application of the fundamental

⁸⁵ See, e.g., Case C-470/04, N v. Inspecteur van de Belastingdienst Oost/kantoor Almelo, 2006 E.C.R. I-7409, ¶¶ 24-28 (100% ownership); Case C-446/04, Test Claimants in the FII Group Litig. v. Commissioners of Inland Revenue, 2006 E.C.R. I-11753, ¶ 37 (100% ownership, directly or indirectly); *Baars*, 2000 E.C.R. I-2787, ¶¶ 9, 20-22 (100% ownership); Case C-524/04, Test Claimants in the Thin Cap Group Litig. v. Commissioners of Inland Revenue, 2007 E.C.R. I-2107, ¶ 32 (75% ownership); Case C-157/05, Holböck v. Finanzamt Salzburg-Land, 2007 E.C.R. I-4051, ¶¶ 9, 23-24 (66.66% ownership); Case C-492/04, Lasertec Gesellschaft für Stanzformen mbH v. Finanzamt Emmendingen, 2007 E.C.R. I-3775, ¶ 23 (66.66% ownership); see also Jens Schöpfeld, *Hinzurechnungsbesteuerung und Europäisches Gemeinschaftsrecht* 205-16 (2005).

⁸⁶ See *Lasertec*, 2007 E.C.R. I-3775, ¶¶ 21-22 (referring to German law where shareholders’ influence will be determined in light of the ownership percentages of other shareholders; actual exercise of control will be considered, regardless of ownership percentage).

⁸⁷ See *FII Group Litig.*, 2006 E.C.R. I-11753, ¶¶ 58-70.

⁸⁸ EC Treaty, note 51, art. 56(1).

⁸⁹ *Id.* art. 43.

⁹⁰ The ECJ has limited the scope of Article 56(1) by denying its application in situations “primarily” affecting another fundamental freedom. See Case C-196/04, Cadbury Schweppes plc v. Commissioners of Inland Revenue, 2006 E.C.R. I-7995, ¶ 33; Case C-452/04, Fidium Finanz AG v. Bundesanstalt für Finanzdienstleistungsaufsicht, 2006 E.C.R. I-9521, ¶ 34; see also Cases C-282/04 and C-283/04, Commission v. Netherlands, 2006 E.C.R. I-9141 (nontax case primarily concerning the freedom of capital movement); Axel Cordewener, Georg W. Kofler & Clemens Philipp Schindler, *Free Movement of Capital, Third Country Relationships and National Tax Law: An Emerging Issue Before the ECJ*, 47 Eur. Tax'n 107 (2007); Axel Cordewener, Georg W. Kofler & Clemens Philipp Schindler, *Free Movement of Capital and Third Countries: Exploring the Outer Boundaries with Lasertec, A and B and Holböck*, 47 Eur. Tax'n 371 (2007).

⁹¹ Parent-Subsidiary Directive, note 68, at 7.

freedoms or relieve Member States from the obligation to adhere to the EC Treaty,⁹² but it does mean that the selective relief issue should not arise in cases covered by the Directive.

In a woefully complex series of cases, the ECJ has held that limiting economic double tax relief to domestic dividends conflicts with the EC fundamental freedoms, which prohibit discrimination against cross-border transactions in comparison to similar domestic transactions.⁹³ The cases reveal concern for the locational distortions caused by the failure of Member States to extend domestic economic double tax relief to cross-border investments, rather than concern for the form, timing, or characterization distortions created by the general failure of a state to relieve economic double tax.⁹⁴ Accordingly, under the present state of ECJ jurisprudence, a Member State may choose whether or not to relieve economic double taxation, but it may not confine such relief to domestic dividends.

A. *Inbound Dividends*

1. *Constitutional Challenges*

Recall that from the perspective of the shareholder's residence state, a dividend is considered to be "inbound" if it is paid by a corporation resident in another state. In three major cases involving individual shareholders, the ECJ held that Member States could not categorically refuse to extend to inbound dividends economic double tax relief measures applicable to domestic dividends. Each case involved a different method of economic double tax relief provided at the individual shareholder level: *Verkooijen* involved the Dutch dividend exemption;⁹⁵ *Lenz* involved the Austrian schedular method;⁹⁶

⁹² See, e.g., Case C-379/05, *Amurta SGPS v. Inspecteur van de Belastingdienst*, 2007 E.C.R. I-9569, ¶¶ 16-17; Case C-471/04, *Finanzamt Offenbach am Main-Land v. Keller Holding GmbH*, 2006 E.C.R. I-2107, ¶ 45; 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, ¶¶ 52-54; Case C-168/01, *Bosal Holding BV v. Staatssecretaris van Financiën*, 2003 E.C.R. I-9409, ¶¶ 42-43; see also *Georg Kofler, Doppelbesteuerungsabkommen und Europäisches Gemeinschaftsrecht* 826-40 (2007).

⁹³ For an overview of the ECJ jurisprudence in this area, see *Confédération Fiscale Européenne (CFE), The Consequences of the Verkooijen Judgment*, 42 Eur. Tax'n 241, 241-42 (2002).

⁹⁴ See Section II.A.

⁹⁵ Case C-35/98, *Staatssecretaris van Financiën v. Verkooijen*, 2000 E.C.R. I-4071. Under dividend exemption, corporations are liable for tax on their profits, but dividends paid from after-tax corporate income are either partially or fully excluded from the income of shareholders. See id. ¶¶ 3-11.

⁹⁶ Case C-315/02, *Lenz v. Finanzlandesdirektion für Tirol*, 2004 E.C.R. I-7063. Under a schedular system, the corporation is liable for tax on its profits, and the dividends are included in the shareholder's income, but they are taxed at a rate lower than the shareholder's marginal rate. See id. ¶¶ 3-12. Note that complete integration could be achieved

and *Manninen* involved the Finnish shareholder imputation credit.⁹⁷ In each case, the Member State provided relief from economic double taxation to resident shareholders who received domestic dividends, but denied such relief to resident shareholders receiving dividends from corporations established in other Member States.⁹⁸ In all three cases, shareholders in receipt of cross-border dividends challenged the limitations as violations of the freedom of capital movement.⁹⁹

Joined at times by the Danish, French, and British governments, the Austrian and Finnish governments argued that there was an objective difference between domestic and foreign corporations that justified a difference in taxation of their dividends.¹⁰⁰ The objective difference arose because the defendant states did not and could not collect corporate tax from nonresident corporations that paid inbound dividends to domestic shareholders.¹⁰¹ With respect to the domestic dividends, by contrast, the defendant states collected corporate-level taxes. Thus, for domestic dividends, the defendant states collected two taxes (one from the corporation and one from the shareholder), and relieved one. By comparison, in the case of inbound dividends, the defendant states collected only one tax (from the shareholder) and they did not relieve it. The states reasoned that in both cases, they cumulatively levied only a single tax on the corporate profits.¹⁰² Extending economic double tax relief to foreign dividends, the states contended,

by reducing the shareholder rate to zero, and this would be the same as excluding the dividend from the shareholder's income.

⁹⁷ Case C-319/02, *Manninen*, 2004 E.C.R. I-7477. Under an imputation system, corporations are liable for tax on their profits at the corporate tax rate, but their shareholders receive credit for the corporate taxes paid. The credit offsets the tax due on the dividend at the shareholder level. See *id.* ¶¶ 6-11. By altering the amount of the credit, a country can achieve complete or partial integration.

⁹⁸ *Manninen*, 2004 E.C.R. I-7477, ¶ 10; *Lenz*, 2004 E.C.R. I-7063, ¶¶ 6-11; *Verkooijen*, 2000 E.C.R. I-4071, ¶¶ 9-11.

⁹⁹ *Manninen*, 2004 E.C.R. I-7477, ¶ 17; *Lenz*, 2004 E.C.R. I-7063, ¶ 13-15; *Verkooijen*, 2000 E.C.R. I-4071, ¶¶ 1-2. These cases arose in national courts and were referred to the ECJ for preliminary ruling. *Manninen*, 2004 E.C.R. I-7477, ¶ 2; *Lenz*, 2004 E.C.R. I-7063, ¶¶ 1-2; *Verkooijen*, 2000 E.C.R. I-4071, ¶¶ 1-2. For the underlying law governing the referral process, see EC Treaty, note 52, art. 234.

¹⁰⁰ *Manninen*, 2004 E.C.R. I-7477, ¶¶ 27-30; *Lenz*, 2004 E.C.R. I-7063, ¶ 28.

¹⁰¹ *Manninen*, 2004 E.C.R. I-7477, ¶¶ 27-30; *Lenz*, 2004 E.C.R. I-7063, ¶ 28 (citing Case C-279/93, *Finanzamt Köln-Altstadt v. Schumacker*, 1995 E.C.R. I-225; Case C-35/98, *Verkooijen*, 2000 E.C.R. I-4071). Subject to tax treaty limitations, states may tax nonresident corporations on a source basis on profits earned within their territory. But these cases did not involve dividends paid out of corporate profits sourced in the shareholder's state, and for the sake of simplicity we assume throughout the Article that a corporation's profits are sourced only in its residence state.

¹⁰² See *Manninen*, 2004 E.C.R. I-7477, ¶ 30; *Lenz*, 2004 E.C.R. 7063, ¶ 28. This is the same argument set forth by the Netherlands as part of its fiscal cohesion justification, discussed in text accompanying notes 111-16. See *Verkooijen*, 2000 E.C.R. I-4071, ¶¶ 49-51.

would result in the defendant state collecting no tax at all on inbound dividends.¹⁰³

In the ECJ's view, however, recipients of domestic and inbound dividends were similarly situated because both faced the prospect of economic double taxation of corporate profits. For the inbound dividend, the risk of economic double taxation arose because the corporation's state may have already taxed the distributing corporation on the profits constituting the dividend.¹⁰⁴ Since domestic and inbound dividends were similarly at risk for economic double taxation, the court held that the Member States could not limit economic double tax relief to domestic dividends.¹⁰⁵ In all three cases, the ECJ ruled that selective relief violated the freedom of capital movement because it dissuaded residents from investing in companies established in other Member States and restricted the ability of corporations established in other Member States to raise capital from the residents of the defendant state.¹⁰⁶ The Member States therefore violated the EC Treaty's non-discrimination principle by preferring domestic to intra-Community commerce. By requiring Member States to grant economic double tax relief on inbound (as well as domestic) dividends, the court thereby seemed to endorse capital export neutrality.¹⁰⁷ The court further reasoned that if the states' tax policy aim was to reduce economic double taxation, that goal would not be harmed by extending relief to inbound dividends.¹⁰⁸

2. Member States' Defenses

Having found that the Member States' selective relief of economic double taxation violated the EC Treaty, the ECJ considered and rejected a number of defenses and justifications offered by the Member States. First, and unsurprisingly, the ECJ held that the public policy goal of stimulating domestic investment did not justify discriminating against cross-border investment.¹⁰⁹ Second, although the court conceded that extension of relief to inbound dividends would lower the

¹⁰³ See *Verkooijen*, 2000 E.C.R. I-4071, ¶ 52.

¹⁰⁴ *Manninen*, 2004 E.C.R. I-7477, ¶¶ 35-37 (citing Case C-107/94, *Asscher v. Staatssecretaris van Financiën*, 1996 E.C.R. I-3089, ¶¶ 41-49; Case C-234/01, ¶¶ 41-49; *Gerritse v. Finanzamt Neukölln-Nord*, 2003 E.C.R. I-5933, ¶¶ 47-54); *Lenz*, 2004 E.C.R. I-7063, ¶ 33.

¹⁰⁵ See note 104.

¹⁰⁶ *Manninen*, 2004 E.C.R. I-7477, ¶¶ 20, 22-23; *Lenz*, 2004 E.C.R. I-7063, ¶¶ 18, 20-21; *Verkooijen*, 2000 E.C.R. I-4071, ¶¶ 31, 34-35.

¹⁰⁷ The endorsement of capital export neutrality was tempered in *Manninen*. See text accompanying note 113.

¹⁰⁸ *Lenz*, 2004 E.C.R. I-7063, ¶ 38.

¹⁰⁹ *Verkooijen*, 2000 E.C.R. I-4071, ¶ 48 (holding that "aims of a purely economic nature," such as the desire to stimulate private investment in Dutch firms, "cannot constitute

shareholder state's tax revenue, the court held, in accordance with longstanding precedent, that the need for tax revenue could not justify a restriction of a fundamental freedom.¹¹⁰

a. *Fiscal Cohesion Defense*

Supported by Member States with similar limitations in their own national tax systems, the defendant Member States argued that selective relief of economic double taxation was needed to maintain "fiscal cohesion."¹¹¹ Fiscal cohesion is a "rather diffuse concept" in European taxation used to refer to cases in which two or more different provisions of a country's tax code are meant to interact in order to achieve a single overall effect.¹¹² Most commonly, fiscal cohesion is used to refer to arrangements by which a country ensures single taxation of income while avoiding double taxation.¹¹³ Although one portion of the overall arrangement may appear to be discriminatory or restrictive when viewed in isolation, when all parts of the scheme are considered together, the superficial discrimination or restriction disappears.

The defendant states' fiscal cohesion defense was similar to their argument that domestic and inbound dividends were dissimilar and therefore could be treated dissimilarly. The states argued that since they assessed corporate tax only against domestic corporations, relieving economic double taxation on domestic, but not foreign dividends was fiscally coherent.¹¹⁴ The ECJ rejected those arguments—at least

an overriding reason in the general interest justifying a restriction of a fundamental freedom guaranteed by the Treaty").

¹¹⁰ *Manninen*, 2004 E.C.R. I-7477, ¶ 49; *Lenz*, 2004 E.C.R. I-7063, ¶ 40; *Verkooijen*, 2000 E.C.R. I-4071, ¶ 59.

¹¹¹ *Manninen*, 2004 E.C.R. I-7477, ¶ 40-49; *Lenz*, 2004 E.C.R. I-7063, ¶¶ 34-39; *Verkooijen*, 2000 E.C.R. I-4071, ¶¶ 49-51.

¹¹² *Manninen*, 2004 E.C.R. I-7477, ¶ 51 (Opinion of Advocate General Kokott). The fiscal cohesion justification derives from Case C-204/90, *Bachmann v. Belgium*, 1992 E.C.R. I-249, in which the ECJ found that Belgium violated the EC Treaty by allowing deductions for insurance premiums paid to domestic, but not foreign insurers. That difference in tax treatment was justified, however, because it was fiscally coherent since Belgium paired it with a difference in tax treatment of the insurance award. Belgium taxed insurance awards in cases where the premiums had been deducted (domestic insurance) and exempted insurance awards in cases where the premiums had not been deducted (foreign insurance). See id. ¶¶ 27-28. For criticism of *Bachmann* and fiscal cohesion, see Ruth Mason, *A Theory of Tax Discrimination* 28-33 (Jean Monnet Working Paper 09/06, 2006), available at http://papers.ssrn.com/abstract_id=978880.

¹¹³ *Manninen*, 2004 E.C.R. I-7477, ¶ 51 (Opinion of Advocate General Kokott) ("The concept generally means no more than avoiding double taxation or ensuring that income is actually taxed, but only once"). The denial of an interest deduction for borrowings invested in tax-exempt bonds is a simple example of fiscal cohesion.

¹¹⁴ See *Manninen*, 2004 E.C.R. I-7477, ¶¶ 40-49; *Lenz*, 2004 E.C.R. I-7063, ¶¶ 34-39; *Verkooijen*, 2000 E.C.R. I-4071, ¶¶ 49-51.

in the case of the Dutch and Austrian relief methods—because those states could not establish a direct link between the taxation of the domestic corporation's profits and the tax preference on domestic dividends.¹¹⁵ For example, Austria did not make the domestic dividend preference contingent on the payment of domestic corporate tax by the corporation.¹¹⁶

b. Need to Coordinate Relief with Corporate Level Tax

An additional question concerned the relevance of the amount of corporate tax to the obligation of the shareholder's residence state to grant relief. A state usually determines the extent of the relief to be offered at the shareholder level by considering the tax at the corporate level. Granting the same tax preference to inbound and domestic dividends without respect to the amount of tax paid at the corporate level could frustrate the shareholder state's purpose in enacting shareholder relief. To take an extreme case, if the other country assessed no corporate tax, granting shareholder-level economic double tax relief would result in a preference for foreign over domestic dividends. Likewise, if the corporation's state relieved economic double taxation at the corporate level, perhaps by taxing the corporation only on retained profits, but not distributed profits, then there also would be no need for the shareholder's state to alleviate economic double taxation. More generally, it is not unusual for corporate profits to be subject to different effective tax rates in different countries, because nominal corporate tax rates and tax bases vary widely, as do the presence and content of corporate tax expenditures, such as accelerated depreciation and tax holidays. Thus, granting economic double tax relief on inbound dividends raises difficult coordination questions, particularly in a common market involving twenty-seven different national corporate tax systems.

Despite these concerns, in *Lenz* the ECJ held that Austria had to extend to inbound dividends the preferential tax rate applicable to domestic dividends, regardless of the amount of corporate tax paid in the other state.¹¹⁷ This was because Austria did not condition its tax preference for domestic dividends upon the payment of a certain amount of corporate tax by the domestic corporation.¹¹⁸ For example, if an Austrian corporation distributed earnings that had not been taxed at the corporate level (for example, because a tax preference was available to the corporation for that item of income), an Austrian

¹¹⁵ See *Lenz*, 2004 E.C.R. I-7063, ¶¶ 38-53; *Verkooijen*, 2000 E.C.R. I-4071, ¶¶ 55-62.

¹¹⁶ See *Lenz*, 2004 E.C.R. I-7063, ¶¶ 34-36.

¹¹⁷ *Id.* ¶ 42.

¹¹⁸ *Id.*

shareholder nevertheless received the schedular tax rate preference.¹¹⁹ The court therefore rejected Austria's argument that any relief in the shareholder's state had to be coordinated with the amount of corporate tax paid.¹²⁰ Although the court was not explicit, it presumably reasoned that Austria could not introduce a subject-to-double-tax requirement for inbound, but not domestic, dividends.

Unlike in *Lenz*, in *Manninen* the ECJ expressly conceded that shareholders of domestic and foreign corporations could be in different situations, depending on the tax treatment of the corporation.¹²¹ *Manninen* marked an important new development in the ECJ's analysis because the court recognized the relevance of the tax treatment of the underlying corporate profits by other states to the appropriate tax treatment of such dividends in the shareholder's state. The Finnish system for economic double tax relief differed from the Dutch and Austrian schemes considered in *Verkooijen* and *Lenz* because in Finland, if the dividend-paying corporation was not fully taxable on the amount distributed as a dividend, it had to pay additional or "compensatory" tax at the time of the distribution.¹²² As a result, in Finland, no shareholder imputation credit was granted on corporate profits that had not already been fully subject to corporate income taxation. Thus, the matching between the corporate and shareholder taxes was more precise in Finland than in the Netherlands or Austria. Acknowledging this, the ECJ held that Finland could determine the amount of the credit for inbound dividends by reference to the corporate tax paid in the other state.¹²³

Manninen thus introduced the notion that a state's conferral of economic double tax relief measures on resident shareholders in receipt of inbound dividends could vary depending on the tax treatment of the dividend-paying corporation by a fellow Member State.¹²⁴ The

¹¹⁹ For arguments for and against allowing corporate tax preferences to pass up to shareholders under integration, see ALI Integration Study, note 2, at 59-63.

¹²⁰ *Lenz*, 2004 E.C.R. I-7063, ¶ 43.

¹²¹ *Manninen*, 2004 E.C.R. I-7477, ¶ 34.

¹²² Id. ¶ 53 ("[I]n Finnish law the tax credit always corresponds to the amount of the tax actually paid by way of corporation tax by the company which distributes the dividends. Should the tax paid by way of corporation tax turn out to be less than the amount of the tax credit, the difference is charged to the company making the distribution by means of an additional tax."). For more on compensatory taxation as a method to prevent corporate-level tax preferences from passing through to shareholders under integrated systems, see ALI Integration Study, note 2, at 67-92 (specifically discussing the old German system as well as the British ACT).

¹²³ *Manninen*, 2004 E.C.R. I-7477, ¶ 54 ("[T]he calculation of [the] credit . . . must take account of the tax actually paid by the company established in that other Member State . . .").

¹²⁴ Id.

court subsequently explicitly confirmed this reasoning.¹²⁵ Notably, in the *FII Group Litigation* case, the ECJ expressly stated that if the corporate tax rate in the foreign state were higher than the corporate tax rate in the shareholder's state, the shareholder's state would be under no obligation to provide economic double tax relief in excess of what it provided in wholly domestic situations.¹²⁶ Although it would violate capital export neutrality, the court endorsed the shareholder state's entitlement to limit imputation credits in cases where the foreign corporate tax was higher.

The ECJ therefore seems to take the view that domestic and inbound dividends are comparable only to the extent that they are similarly burdened by corporate taxes. This is better understood as a nondiscrimination approach, rather than one that endorses either capital export neutrality or capital import neutrality.¹²⁷ The ECJ takes as a given the Member State's tax system, however constituted. Major tax policy choices—such as whether to pursue capital import neutrality or capital export neutrality, or whether to enact a classical or integrated corporate tax—lie within the sole competence of the Member State, and the ECJ does not seem to second-guess those decisions.¹²⁸ The court demands, however, that once the Member State has deter-

¹²⁵ Case C-292/04, *Meilicke v. Finanzamt Bonn-Innenstadt*, 2007 E.C.R. I-1835; Case C-446/04, *Test Claimants in the FII Group Litig. v. Commissioners of Inland Revenue*, 2006 E.C.R. I-11753;

¹²⁶ The ECJ held that the

Member State is obliged to grant a tax credit only up to the limit of the amount of corporation tax for which the company receiving the dividends is liable. It is not required to repay the difference, that is to say, the amount paid in the Member State of the company making the distribution which is greater than the amount of tax payable in the Member State of the company receiving it.

FII Group Litig., 2006 E.C.R. I-11753, ¶ 52. *FII Group Litigation* was a logical extension of an earlier juridical double tax case in which the court held that a foreign tax credit limitation was not contrary to EC law. Case C-336/96, *Gilly v. Directeur des Services Fiscaux du Bas-Rhin*, 1998 E.C.R. I-2793.

¹²⁷ See Jacques Malherbe, Philippe Malherbe, Isabelle Richelle & Eduardo Traversa, *The Impact of the Rulings of the European Court of Justice in the Area of Direct Taxation* 70-73 (2008) (characterizing the ECJ's approach as one of "capital movement neutrality"). But see Michael J. Graetz & Alvin C. Warren, Jr., *Dividend Taxation in Europe: When the ECJ Makes Tax Policy*, 44 Common Mkt. L. Rev. 1577, 1606 (2007) [hereinafter *Dividend Taxation*] (arguing that the ECJ's dividend decisions could be seen as "prohibit[ing] discrimination based on the destination, but not the origin, of investment"); Michael J. Graetz & Alvin C. Warren, Jr., *Income Tax Discrimination and the Political and Economic Integration of Europe*, 115 Yale L.J. 1186 (2006) [hereinafter *Income Tax Discrimination*] (arguing more generally that the ECJ's approach to tax cases is incoherent because it tries simultaneously to eliminate discrimination based on both the origin and destination of economic activity, an impossible goal in the absence of harmonization of Member States' tax systems).

¹²⁸ 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, ¶ 50.

mined its tax policy goals and the features of its tax system, taxes must be applied consistently to all EU nationals.¹²⁹ In other words, the nondiscrimination principle under EC law requires the extension of domestic tax policy choices to comparable cross-border situations.¹³⁰ Thus, contrary to the arguments of some commentators,¹³¹ in our view, the ECJ has not asserted any preference for capital import or export neutrality, nor has it given priority to tax corporate profits to one jurisdiction over another. The court merely prohibits a Member State from treating cross-border dividends worse than domestic dividends.¹³²

Although the Parent-Subsidiary Directive effectively eliminates the problem of selective economic double tax relief for intra-Community intercorporate direct dividends, the issue may still arise with respect to intercorporate portfolio dividends. In the *FII Group Litigation* case, the ECJ extended the reasoning discussed above to inbound intercorporate dividends.¹³³

B. Outbound Dividends

Recall that from the perspective of the corporation's state, a dividend is considered to be "outbound" if it is paid to a shareholder resident in another state. The outbound dividend cases concern economic double taxation arising when the corporate tax combines with the

¹²⁹ *FII Group Litig.*, 2006 E.C.R. I-11753, ¶ 35-36.

¹³⁰ See F. Alfredo García Prats, Is It Possible to Set a Coherent System of Rules on Direct Taxation Under EC Law Requirements?, in *A Vision of Taxes Within and Outside European Borders: Festschrift in Honor of Prof. Dr. Frans Vanistendael* 429, 438-39 (Luc Hinnekins & Philippe Hinnekins eds., 2008); Koen Lenaerts, "United in Diversity": Also in *Fiscalibus?*, in *A Vision of Taxes*, *supra*, at 617, 618.

¹³¹ See, e.g., Graetz & Warren, *Dividend Taxation*, note 127, at 1623 app.; Graetz & Warren, *Income Tax Discrimination*, note 127, at 1220.

¹³² See Servaas van Thiel, *Why the ECJ Should Interpret Directly Applicable European Law as a Right to Intra-Community Most-Favoured-Nation Treatment*: pt. 1, 47 *Eur. Tax'n* 263, 268-69 (2007); see also Fred C. de Hosson, *On the Controversial Role of the European Court in Corporate Tax Cases*, 34 *Intertax* 294, 300 & n.36 (2006); Frans Vanistendael, *Does the ECJ Have the Power of Interpretation to Build a Tax System Compatible with the Fundamental Freedoms?*, 17 *EC Tax Rev.* 52, 63-65 (2008).

¹³³ Interestingly, the ECJ held that as long as the "level" of tax on domestic and inbound dividends was the same, it did not matter if a Member State employed two different methods to relieve economic double taxation, namely exemption for domestic dividends and indirect foreign tax credits for inbound dividends. *FII Group Litig.*, 2006 E.C.R. I-11753, ¶¶ 48-52. It is not entirely clear how the level of tax would be compared in domestic and cross-border cases, and the ECJ left that determination to the national court. *Id.* ¶ 56. The ECJ also noted that the additional administrative burden on taxpayers in the case of the credit method (as opposed to the exemption method) did not amount to an unconstitutional restriction on the freedom of capital movement, since additional administrative checks were necessary to determine the actual amount of corporate tax paid to the other jurisdiction. *Id.* ¶¶ 53-56.

shareholder-level tax assessed via withholding by the corporation's state.

As with inbound forms of economic double tax relief, there was a question whether Member States violated EC law when they granted relief for domestic dividends, but denied it for outbound dividends. The Commission had argued since at least 2003 that excluding outbound dividends from economic double tax relief violated the EC Treaty.¹³⁴ As with inbound dividends, the ECJ found that, under certain circumstances, a state granting relief from economic double taxation to domestic dividends must also grant that relief to outbound dividends.¹³⁵

1. *Constitutional Challenges*

The ECJ case involving outbound dividends involved intercorporate distributions. In *ACT Group Litigation*,¹³⁶ the most important question for our purposes was whether the United Kingdom had to relieve economic double taxation on dividends paid from British corporations to corporate shareholders resident in fellow Member States when it allowed domestic corporate shareholders to exempt domestic intercorporate dividends from income.

The court acknowledged that it previously had held that if a Member State relieved economic double taxation on domestic dividends, it must also do so on inbound dividends.¹³⁷ The court agreed, however, with arguments advanced by the British, German, French, Irish, and Italian governments, and the European Commission, that domestic and outbound dividends were not similar in cases where the corporation's state—the state of source of the dividends—did not collect a shareholder-level tax on the outbound dividend. Therefore, the ECJ held that as long as the corporation's state does not tax the foreign shareholder on the outbound dividend, the corporation's state is not “in the same position, as regards the prevention or mitigation of . . . economic double taxation, as the [shareholder's] State”¹³⁸ In such a case, the corporation's state need not relieve economic double

¹³⁴ The Commission argued that “[u]nder the EC Treaty Member States cannot effectively tax outbound dividends higher than domestic dividends” because article 56 of the EC Treaty “prohibits a Member State from granting more favourable treatment to investments by domestic shareholders than to investments by foreign shareholders.” Communication on Dividend Taxation, note 64, at 17.

¹³⁵ 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.

¹³⁶ Id. The case arose out of litigation brought by twenty-eight different corporate groups. The U.K. court formed this action using the claims of four of the groups. Id. ¶ 25.

¹³⁷ Id. ¶¶ 55-56 (citing Case C-319/02, Manninen, 2004 E.C.R. I-7477, ¶¶ 35-36).

¹³⁸ Id. ¶ 58.

taxation on outbound dividends, even if it relieves economic double taxation on domestic dividends.

The source state ordinarily collects the shareholder-level tax on outbound dividends via withholding, so the court's ruling amounts to a requirement that the source state waive withholding in order to avoid the obligation to extend its domestic economic double tax relief regime to foreign shareholders. Of course, even in cases where the source state does not tax the outbound dividend, there nevertheless might be economic double taxation because the shareholder's state might tax the dividend. In that case, it would be the responsibility of the shareholder's residence state to relieve the resulting economic double taxation to the extent required under the court's jurisprudence covering inbound dividends.

In *ACT Group Litigation*, the United Kingdom was the corporation's state, and it could not control whether the shareholder's residence state would tax the dividend in the hands of the shareholder. Thus, the only way the United Kingdom could ensure that the corporate profits would be taxed only once would be to forgo both the withholding tax on the foreign shareholder and the corporate tax.¹³⁹ In the ECJ's view, this was too much to ask because it would force the United Kingdom to "abandon its right to tax a profit generated through an economic activity undertaken on its territory."¹⁴⁰ The court's holding is consistent with the Parent-Subsidiary Directive, under which the residence state of the distributing company forgoes collecting withholding taxes from the foreign shareholder but retains the power to tax the distributing corporation on its profits.¹⁴¹

Although states could reliably avoid economic double taxation in the Community if corporate profits were never taxed at source, the ECJ declined to upset long-established international tax priority rules that grant the source state first priority to tax corporate profits.¹⁴² Permitting corporate taxation at source meant that a risk of economic double taxation remained, since the shareholder's residence state also might tax the dividends. The court showed no special concern about this risk, which suggests that its primary goal was to ensure that there

¹³⁹ *Id.* ¶ 59.

¹⁴⁰ *Id.*

¹⁴¹ The court found the Parent-Subsidiary Directive relevant to its decision. *Id.* ¶ 60; see Parent-Subsidiary Directive, note 68, art. 7; see also *id.* art. 5 (prohibiting source withholding taxation of only source-based taxation of the foreign parent company, not residence-based taxation of the distributing subsidiary). Echoing the line of reasoning it advanced in *Schumacker*, the ECJ stated that the shareholder's state normally is better placed to determine the shareholder's ability to pay tax. *ACT Group Litig.*, 2006 E.C.R. I-11673, ¶ 60 (citing Case C-279/93, *Finanzamt Köln-Altstadt v. Schumacker*, 1995 E.C.R. I-225).

¹⁴² The ECJ cited the source state priority rule. *ACT Group Litig.*, 2006 E.C.R. I-11673, ¶ 59.

would not be selective or discriminatory relief of economic double taxation, not to ensure that economic double taxation would be eliminated on all intra-Community dividends.

According to the court, however, the result in *ACT Group Litigation* would have been different if the corporation's state taxed the foreign shareholder on the outbound dividend.¹⁴³ If the United Kingdom taxed the outbound dividend (via withholding), the position of foreign and domestic shareholders would become comparable.¹⁴⁴ In that case, the foreign shareholder would be subjected to economic double taxation "solely because of the exercise by [the United Kingdom] of its taxing powers . . . irrespective of any taxation in another Member State . . ."¹⁴⁵ In that case, the United Kingdom would be obliged to grant the foreign shareholder economic double tax relief equivalent to that granted to domestic shareholders.¹⁴⁶

2. Member States' Defenses

Although many of the defenses for different treatment of domestic and outbound dividends mirrored those made with respect to inbound dividends, including revenue arguments and the argument that outbound and domestic dividends were not similar enough to demand similar tax treatment, the states advanced novel arguments in the context of outbound dividends.

a. Avoidance of Double Relief

First, Member States expressed concern that cross-border dividends should not be treated more favorably than domestic dividends, which they argued might occur if both the source and the residence state had to confer economic double tax relief on cross-border dividends.¹⁴⁷ For example, if a shareholder receiving a cross-border dividend were entitled to imputation credits from both the source and residence states, she might pay less net tax on the dividend than a shareholder receiving a domestic dividend. The desire to prevent double relief gave rise to the argument that only one state should be obliged to relieve economic double taxation. The ECJ, however, refused to assign the obli-

¹⁴³ Id. ¶ 68.

¹⁴⁴ Id. The United Kingdom taxed certain outbound dividends as permitted under its tax treaties. Id. ¶¶ 14-20.

¹⁴⁵ Id. ¶ 70.

¹⁴⁶ Id. The national court would determine whether equivalent relief was granted on domestic and outbound dividends. Id. ¶ 71.

¹⁴⁷ 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, ¶ 32.

gation to only one state.¹⁴⁸ Instead, the court placed an independent obligation on both the source and residence states to relieve economic double taxation on cross-border dividends to the same extent that they relieve economic double taxation on domestic dividends.¹⁴⁹ From the perspective of nondiscrimination, this was a sensible approach because economic double taxation arises when the corporate tax combines with a shareholder-level tax assessed by either the corporation's state or the shareholder's state. Thus, the independent obligation on each state to relieve economic double tax on cross-border dividends to the same extent as on domestic dividends should not result in more favorable treatment of cross-border dividends than domestic dividends.¹⁵⁰

b. International Tax Priority Rule

A related, but equally unsuccessful, argument was based on the *Schumacker* line of cases, in which the court relied on an international law tax priority rule to establish an EC law tax priority rule.¹⁵¹ The *Schumacker* line of cases caused speculation that the international tax law treatment of cross-border dividends would inform the Member States' obligations under EC law. Thus, despite the objections of the Commission,¹⁵² some commentators concluded¹⁵³ and some Member States argued¹⁵⁴ that since the primary responsibility to relieve economic double taxation of cross-border dividends falls to the shareholder's state under international law, the ECJ should enshrine that

¹⁴⁸ See *ACT Group Litig.*, 2006 E.C.R. I-11673, ¶ 59.

¹⁴⁹ See *id.* ¶ 66.

¹⁵⁰ In order for corporate profits to be taxed only at the corporate level, and not at the shareholder level, both the shareholder-level tax assessed by the corporation's residence state and the shareholder-level tax assessed by the shareholder's residence state must be relieved. While that technically may be described as "double relief," the result is the desired one: a single layer of tax on corporate profits, collected at the level of the corporation. The calculation provided by Graetz & Warren, *Dividend Taxation*, note 127, at 1600 n.70, suggests otherwise, but does so by assuming that the source state would have to grant a credit across the border even if it does not levy a withholding tax, a result ruled out by *ACT Group Litig.*, 2006 E.C.R. I-11763, ¶ 59.

¹⁵¹ See Case C-279/93, *Finanzamt Köln-Altstadt v. Schumacker*, 1995 E.C.R. I-225 (holding that since international law placed the primary duty to grant tax relief for personal expenses on the residence state, the host state need not grant such relief, except in cases where the residence state was unable to grant relief).

¹⁵² Communication on Dividend Taxation, note 64, at 17 ("Under the EC Treaty Member States cannot effectively tax outbound dividends higher than domestic dividends.").

¹⁵³ See Guido de Bont, *Taxation and the Free Movement of Capital and Payments*, 4 EC Tax Rev. 136, 141 (1995); Otto H. Jacobs, *Corporation Income Tax Systems in the European Union: An Analysis of their Effects on Competition and Reform Proposals*, 27 Intertax 264, 272 (1999). But see Joachim Englisch, *Dividendenbesteuerung* 326 (2005).

¹⁵⁴ See Case E-1/04, *Fokus Bank ASA v. Norway*, 1 C.M.L.R. 10 (Eur. Free Trade Area Ct. 2005).

principle as part of EC law. The ECJ rejected the argument, holding that, as with inbound dividends, if the Member State taxes the shareholder on the outbound dividend, then it must relieve economic double taxation to the same extent as it does on domestic dividends.¹⁵⁵

3. Relevance of Bilateral Tax Treaties

If the source state is obliged to relieve economic double taxation on outbound dividends only when it taxes the foreign shareholder on the dividend, and such taxes are generally collected via withholding, *ACT Group Litigation* naturally raised questions concerning the result under EC law when the source state had a bilateral tax treaty with the residence state under which the withholding tax was fully credited.¹⁵⁶ In two decisions, *Denkavit Internationaal*¹⁵⁷ and *Amurta*,¹⁵⁸ the ECJ held that Member States may shift the obligation to relieve economic double taxation to another state via a tax treaty.¹⁵⁹ Both cases concerned national tax systems under which domestic intercorporate dividends were exempt, while outbound intercorporate dividends were subject to withholding taxes.¹⁶⁰ The result in both cases was double tax relief for domestic dividends, but collection of two layers of tax on outbound dividends: one from the corporation and one from the shareholder via withholding.¹⁶¹ Following its precedent in *ACT Group Litigation*, in both cases the ECJ found that such differential tax treatment was discriminatory and therefore prohibited in principle.¹⁶²

¹⁵⁵ 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, ¶ 70.

¹⁵⁶ Previously, the EFTA court had held that the tax treaty was irrelevant to the discrimination inquiry, since a Member State of the European Economic Area could not shift its obligation to comply with the EEA Agreement's fundamental freedoms to another Contracting Party by relying on the latter to make good for discrimination caused by the former's legislation. See *Fokus Bank*, 1 C.M.L.R. 10 (2005). The EFTA countries are Iceland, Liechtenstein, and Norway. They are party, along with the EU Member States, to the Agreement on European Economic Area, which provides for the freedom of movement of goods, workers, services, and capital and prohibits nationality discrimination within the EEA. See Carl Baudenbacher, *The EFTA Court: Legal Framework and Case Law* (2006).

¹⁵⁷ Case C-170/05, *Denkavit Internationaal BV v. Ministre de l'Économie, des Finances et de l'Industrie*, 2006 E.C.R. I-11949.

¹⁵⁸ Case C-379/05, *Amurta SGPS v. Inspecteur van de Belastingdienst/Amsterdam*, 2007 E.C.R. I-9569.

¹⁵⁹ See id. ¶ 17; *Denkavit Internationaal*, 2006 E.C.R. I-11949, ¶ 43.

¹⁶⁰ See *Amurta*, 2007 E.C.R. I-9569, ¶ 8; *Denkavit Internationaal*, 2006 E.C.R. I-11949, ¶ 3.

¹⁶¹ See *Amurta*, 2007 E.C.R. I-9569, ¶ 12; *Denkavit Internationaal*, 2006 E.C.R. I-11949, ¶ 5 (the statutory withholding rates had been reduced by tax treaties in both cases).

¹⁶² See *Amurta*, 2007 E.C.R. I-9569, ¶ 61; *Denkavit Internationaal*, 2006 E.C.R. I-11949, ¶ 41.

The ECJ held in *Amurta*, however, that the tax treaty was relevant to the discrimination analysis. If a tax treaty provided that the discriminatory withholding tax would be offset by a credit granted by the shareholder's state, that credit could "neutralize" the discrimination.¹⁶³ The source state could thus ensure "compliance with its obligations under the [EC] Treaty through the conclusion of a convention for the avoidance of double taxation with another Member State"¹⁶⁴ Where a Member State points to a tax treaty as a defense to discrimination, it is for the national court to determine whether the discrimination was neutralized.¹⁶⁵ Note however, that if the tax treaty requires the other state to neutralize the discrimination, but, for whatever reason, the other state did not in fact neutralize the discrimination, the burden would shift back to the discriminating state to provide relief.¹⁶⁶

Although states often grant their residents credit for foreign withholding taxes unilaterally (even in the absence of tax treaty obligations), the ECJ stated that the source state could not rely on unilateral neutralization of its discrimination by the residence state.¹⁶⁷

In contrast, the ECJ consistently has held that the effect of tax treaties must be considered in determining whether there has been discrimination.¹⁶⁸ Several arguments support this conclusion. First, the court has long recognized the integral role tax treaties play in international taxation.¹⁶⁹ Second, taking the tax treaty into consideration re-

¹⁶³ *Amurta*, 2007 E.C.R. I-9569, ¶ 84.

¹⁶⁴ Id. ¶ 79; see also 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, ¶ 71.

¹⁶⁵ *Amurta*, 2007 E.C.R. I-9569, ¶ 84.

¹⁶⁶ In *Denkavit Internationaal*, the ECJ held that the obligation in the French-Dutch tax treaty for the Netherlands to credit discriminatory French withholding taxes did not "overcome" the discrimination by France, since the Netherlands in fact had not credited the French withholding taxes. *Denkavit Internationaal*, 2006 E.C.R. I-11949, ¶ 47. The Netherlands did not credit the French withholding because under their tax treaty, the obligation to credit source state dividend withholding was limited to the tax due on the dividends in the shareholder's residence state. Id. ¶ 10. Since the Netherlands exempted the dividend, it was not obliged under the tax treaty to credit the discriminatory withholding tax. Id. ¶ 47; see also *ACT Group Litig.*, 2006 E.C.R. I-11673, ¶ 71 (Opinion of Advocate General Geelhoed) ("It would be no defense, for example, to argue that the home state had been in breach of its double tax convention obligations by failing to relieve the relevant economic double taxation.").

¹⁶⁷ *Amurta*, 2007 E.C.R. I-9569, ¶¶ 77-78.

¹⁶⁸ See, e.g., *Denkavit Internationaal*, 2006 E.C.R. I-11949, ¶¶ 44-49; *ACT Group Litig.*, 2006 E.C.R. I-11673, ¶ 71 (Opinion of Advocate General Geelhoed); Case C-265/04, *Bouanich v. Skatteverket*, 2006 E.C.R. I-923, ¶ 51; Case C-385/00, *De Groot v. Staatssecretaris van Financiën*, 2002 E.C.R. I-11819, ¶ 99; Case C-336/96, *Gilly v. Directeur des Services Fiscaux du Bas-Rhin*, 1998 E.C.R. I-2793.

¹⁶⁹ *ACT Group Litig.*, 2006 E.C.R. I-11673, ¶ 71 (Opinion of Advocate General Geelhoed); see also Kofler, note 92, at 564-604.

flects economic reality.¹⁷⁰ Although the “economic reality” argument also favors consideration of offsetting credits unilaterally granted by the other Member State, there are good reasons to distinguish between unilateral and bilateral “neutralizations” of discriminatory taxes. The effect of the residence state’s credit for the source state’s discrimination is an undesirable shift of tax revenue from an EC law-compliant state to a discriminating state. In cases where the shift is pursuant to a bilateral tax treaty, however, the crediting state presumably negotiated for an offsetting benefit. By contrast, when the credit is unilateral, the crediting state may be resigned to losing revenue simply to maintain a tax-neutral investment climate for its residents. Third, limiting consideration of the tax treatment by the other state to cases in which the other state’s treatment is governed by a tax treaty avoids the untenable situation where the legality of one state’s laws closely depends on unilaterally adopted laws of another state.¹⁷¹

C. Evaluation of the ECJ’s Dividends Jurisprudence

The quite specific framework developed by the ECJ in these cases raises serious questions as to the proper balance between market integration and national sovereignty and the role of the court in striking that balance. While virtually all of the court’s tax jurisprudence has been criticized, commentators have reserved especially sharp criticism for its dividend jurisprudence.¹⁷² Michael Graetz and Alvin Warren recently concluded that the “Court’s dividend jurisprudence fails to hold together substantively, functionally, and rhetorically.”¹⁷³ They particularly objected to the judicial lawmaking they discerned in the ECJ’s dividend jurisprudence and to the lack of coherence in the obligations the court places on the Member States.¹⁷⁴ Doubtless, some of this criticism is warranted, but one wonders what alternatives were available to the court once it decided that differential treatment of cross-border and domestic dividends was discriminatory, an outcome arguably demanded by the court’s broad interpretation of the EC

¹⁷⁰ “[I]f the effect of the [double tax convention] in an individual case were not taken into account, this would ignore the economic reality of that taxable subject’s activity and incentives in a cross-border context.” *ACT Group Litig.*, 2006 E.C.R. I-11673, ¶ 71 (Opinion of Advocate General Geelhoed).

¹⁷¹ See Gerald Toifl, Can a Discrimination in the State of Residence Be Justified by the Taxable Situation in the State of Source?, 5 EC Tax Rev. 165, 167 (1996).

¹⁷² See, e.g., Graetz & Warren, *Dividend Taxation*, note 127, at 1578 (criticizing the court for becoming “deeply enmeshed in fashioning the Member States’ income tax policies”).

¹⁷³ *Id.* at 1622.

¹⁷⁴ *Id.* at 1618.

Treaty prohibition of discrimination. We argue that court's rulings are limited in the following respects.

First, and most important, the ECJ's cross-border dividend rulings do not amount to a requirement that EU Member States relieve economic double taxation. Except for the subset of intercorporate dividends covered by the Parent-Subsidiary Directive, the choice of a classical or integrated system remains entirely with the Member State. A state adopting a classical system for domestic dividends does not violate EC law when it withholds on outbound dividends and taxes inbound dividends, without granting any economic double tax relief. Because a Member State operating a classical tax system subjects corporate profits flowing to domestic shareholders to double taxation, it likewise may subject profits flowing into or out of other EU Member States to double taxation, as long as it does not impose higher double taxes on the cross-border flows than the domestic flows. The ECJ's jurisprudence involved selective relief of economic double taxation. Thus, none of the jurisprudence discussed in this Article would apply to a state electing to maintain full economic double taxation for domestic and cross-border investments.

Second, the ECJ's rulings do not specify what method of economic double tax relief the Member States should use if they decide in favor of integration. The difficulty of coordinating imputation credits with the precise level of taxation in the corporation's state of residence, however, makes shareholder imputation an unattractive policy choice.¹⁷⁵ Thus, most countries that had shareholder imputation systems in Europe repealed them in anticipation of or in response to the court's recent decisions.¹⁷⁶ Only Malta still employs a pure imputation system.¹⁷⁷ Evaluation of the desirability of the practical elimination of imputation as a policy choice depends on an evaluation of the desirability of imputation as a method of economic double tax relief.¹⁷⁸ For example, if Member States can achieve equivalent corporate integration by means of another method, we might conclude that

¹⁷⁵ Lingering questions generated by the court's rulings make that system less practical. For example, what is the precise content of the obligation to extend domestic economic double tax relief to inbound dividends? Must the shareholder's state determine the exact amount of corporate tax borne by the dividend and relieve that amount? If so, how?

¹⁷⁶ Graetz & Warren, *Dividend Taxation*, note 127, at 1618.

¹⁷⁷ Conrad Cassar Torregiani, *Malta: The Imputation System and the European Union*, 46 *Eur. Tax'n* 402 (2006). The U.K. system may still be characterized as an imputation system, although it combines the credit with a rate preference that effectively results in exemption for low-income taxpayers.

¹⁷⁸ See Graetz & Warren, *Dividend Taxation*, note 127, at 1618 (criticizing the ECJ's practical preclusion of the imputation credit and arguing that the choice of method of shareholder relief should depend on compliance and administrative costs and whether the state wants to tax the dividend income at shareholder or corporate rates).

the ECJ has not unduly constrained the tax policy choices of the Member States. Additionally, if, as some commentators have argued,¹⁷⁹ a principal reason for states' selection of the imputation method was that it allowed foreign shareholders to be excluded from double tax relief, then perhaps it is fitting that Member States no longer use it in the common market context.

Third, the court has been criticized for exceeding its institutional competence by placing the primary obligation on the shareholder's residence state to relieve economic double taxation on cross-border dividends,¹⁸⁰ even though the EC Treaty provides no basis for establishing such a priority rule.¹⁸¹ We suggest, however, that the ECJ has not assigned to either state the primary obligation to relieve economic double taxation. Instead, the ECJ has stated that if: (1) a state relieves economic double taxation on domestic dividends, and (2) itself taxes shareholders on dividends, and (3) the profits comprising those dividends have already been taxed, either by the state itself or another Member State, then (4) it also must grant economic double tax relief on the cross-border dividend, unless it has arranged for the other Member State to do so via a tax treaty. This obligation is identical for every state, whether it is taxing in a source or a residence capacity. Thus, the nature of the constitutional constraint on taxation is the same for inbound and outbound dividends. The obligations are also the same whether the shareholder is an individual or corporation, although the state may employ different methods of relief in each situation.¹⁸²

Fourth, each state has obligations to relieve economic double taxation only with respect to double taxation it imposes itself, and only

¹⁷⁹ See Sunley, note 23, at 627-28 ("Most countries that have adopted dividend relief have adopted the imputation credit method, in large part because under existing international norms, it is acceptable to deny this form of dividend relief to foreign shareholders."). Sunley also explained that although other forms of relief could be limited to domestic shareholders, such limitations would be "more troublesome" under international norms. *Id.* at 628; see also Graetz & Warren, *Dividend Taxation*, note 127, at 1584 ("Failing to allow shareholder credits either for dividends paid to foreigners or for corporate taxes paid abroad tends to favour domestic investment over foreign investment, and, as a tax policy matter, this is where most countries have landed as an initial matter.")

¹⁸⁰ Graetz & Warren, *Dividend Taxation*, note 127, at 1611 (tentatively setting forth the conclusion that the ECJ seems to have created a priority rule requiring the residence state to relieve economic double taxation, but acknowledging factors in some cases tending to negate that priority rule).

¹⁸¹ The court's ruling in *Schumacker* notwithstanding, the EC Treaty provides no basis for assigning taxing priorities among Member States, nor does it contain any basis for assigning the duty to relieve economic double taxation among the Member States. See Mason, note 112, at 40-45.

¹⁸² For example, a country is more likely to employ shareholder imputation as the method of relief for individual shareholders, while exemption or a dividends received deduction is more common for corporate shareholders.

when the state relieves economic double taxation on domestic dividends. Thus, the court's rulings should not lead to more favorable treatment of cross-border than domestic dividends.¹⁸³

Fifth, the ECJ's dividend case law does not significantly alter the allocation of taxing jurisdiction among the Member States as provided by the international tax treaty network. To see why requires a little background. Although all Member States face the same EC law obligations and those obligations are the same for both inbound and outbound dividends, the simplest way to understand the constitutional restraints on dividend taxation in Europe is to look separately at inbound and outbound dividends. If a state relieves economic double taxation on domestic dividends, then its obligations for cross-border dividends are as follows. For inbound dividends, the state must relieve economic double taxation imposed by the combination of the tax it levies on the shareholder and the tax levied on the corporate profits by corporation's state. For outbound dividends, the state must relieve economic double taxation it imposes when it taxes both the corporation on its profits and the foreign shareholder on her dividend (via withholding). In other words, if the corporation's state fully relieves economic double taxation for domestic dividends, it must be satisfied with collecting the corporate level tax, and no more. It may not withhold tax on outbound dividends, unless it has shifted its obligation to relieve discriminatory withholding taxes to the shareholder's state via a tax treaty.

As a practical matter, since nearly all the EU Member States have bilateral tax treaties that would neutralize discriminatory withholding taxes on dividends, in most cases Member States may continue to levy withholding taxes on outbound dividends without providing economic double tax relief because the residence state will neutralize the withholding tax by crediting it.¹⁸⁴ In these cases, both corporate taxes and withholding taxes would be collected by the corporation's residence state without economic double tax relief, leaving the taxation of outbound dividends unaffected by the ECJ's rulings. It will be up to the shareholder's state of residence to neutralize the source state's discrimination by way of a credit for the withholding tax and to apply any shareholder-level relief from the economic double taxation arising

¹⁸³ See discussion in Subsection III.B.2.a.

¹⁸⁴ If the source state's withholding is not in fact credited by the residence state, the source state would be obliged to refund the withholding tax itself. The absence of a credit for the source state's withholding could be due to a credit limitation in the residence state. 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, ¶ 4 (noting that the source state's withholding was not credited because residence state operated a participation exemption); see also text accompanying notes 157-58.

from the combination of its own shareholder-level tax and the corporate tax assessed by the corporation's state.

This practical outcome mirrors international practice by placing the onus on the residence state to relieve economic double tax.¹⁸⁵ Thus, the burden to relieve economic double taxation falls primarily on the residence state as a result of its obligations under both EC law and its tax treaties, rather than because the ECJ assigned to the residence state the primary duty to relieve economic double taxation. Assignment of priority to the residence state to relieve economic double tax is not compelled by the EC Treaty, and in the absence of tax treaties, the obligation to relieve economic double taxation applies equally to the source and residence states. Notably, even if the source state arranges to have its shareholder-level tax neutralized by the residence state via a tax treaty, the source state's obligation is discharged only if the residence state actually performs its obligation under the tax treaty and neutralizes the tax. Failure of the residence state to neutralize the withholding could be due to any number of reasons leading to a credit limitation under the tax treaty, such as a participation exemption, losses, low income, and so on. In these cases, the EC obligation reverts to the source state to relieve any economic double taxation it levies.¹⁸⁶

Additionally, the ECJ holding that the tax treaty obligation of the residence state may neutralize discrimination by the source state broke what could have been a vicious circle. A residence state generally would argue that it was obliged under its tax treaties to credit only compulsory foreign taxes and that the taxpayer must exhaust all possibilities for tax reduction in the source state before claiming credits at

¹⁸⁵ Thus, the court's jurisprudence, in most cases, would not change the allocation of tax as provided under tax treaties. See Graetz & Warren, *Dividend Taxation*, note 127, at 1586 (identifying such potential shifts as an important criterion in evaluating the court's jurisprudence and describing the "net result" of tax treaties as "granting the corporate tax base exclusively or primarily to the source country and the investor tax base exclusively or primarily to the residence country"); see also OECD Model Treaty, note 24, art. 10, cmts. 51-56 (suggesting as one possibility that the source state forgo withholding and the residence state allow against the shareholder-level tax whatever relief it normally provides on domestic dividends, in lieu of a credit for the source country's withholding tax, precisely the result reached by the ECJ's jurisprudence).

¹⁸⁶ Dennis Weber has argued that both credit and exemption should be regarded as neutralizing the source state's withholding, as credit and exemption are simply two different methods to eliminate juridical double taxation. See Dennis Weber, *In Search of a (New) Equilibrium Between Tax Sovereignty and the Freedom of Movement Within the EC*, 34 *Intertax* 585, 606-07 (2006). Nevertheless, each method may impose different results on the taxpayer. For example, a final withholding tax in the source state imposes a cost on the taxpayer if the residence state exempts foreign income. See Pasquale Pistone, *Expected and Unexpected Developments of European Integration in the Field of Direct Taxes*, 35 *Intertax* 70, 73 (2007).

home. Prior to *Denkavit Internationaal*¹⁸⁷ and *Amurta*,¹⁸⁸ residence states might have argued that source withholding on dividends was not a compulsory tax, because the withholding violated EC law, at least in cases where the source state granted economic double tax relief on domestic, but not outbound, dividends. The residence state therefore might have refused to credit such withholding taxes. By conditioning the source state's obligation to relieve economic double taxation on the tax treaty obligations of the residence state, however, the ECJ in *Denkavit Internationaal* and *Amurta* precluded this argument.¹⁸⁹

Although the court has limited its intrusion into state tax policy in the ways just described, its jurisprudence nevertheless suffers certain serious drawbacks. For example, the conditionality of the source state's obligation in *Amurta* is a prevalent feature of the court's cross-border dividend jurisprudence,¹⁹⁰ and it creates significant problems. Whether taxing in a source capacity or a residence capacity, a Member State's obligation to relieve economic double taxation is contingent on actions taken by other states. With respect to outbound dividends, a Member State need not relieve economic double taxation it imposes if it has arranged for the residence state to relieve the second layer of tax via a tax treaty, as long as the residence state actually relieves the tax.¹⁹¹ Thus, the source country's obligation is conditioned on the treatment of the dividend by the shareholder's state. In the case of inbound dividends, the obligation is also dependent on the tax treatment in the source state.¹⁹² A residence state employing an imputation system, for example, has to extend such relief on inbound dividends only if the corporation's state taxed the corporation on the profits out of which the dividend was paid.¹⁹³ Also because the residence state is permitted to reduce relief granted to resident shareholders on inbound dividends if the corporate profits were subject to less tax in the source state than the residence state would have levied on a domestic corporation, the extent of the residence state's obligation is

¹⁸⁷ *Denkavit Internationaal*, 2006 E.C.R. I-11949.

¹⁸⁸ Case 379/05, *Amurta SGPS v. Inspecteur van de Belastingdienst*, 2007 E.C.R. I-9569.

¹⁸⁹ See *Denkavit Internationaal*, 2006 E.C.R. I-11949, ¶ 54; *Amurta*, 2007 E.C.R. I-9569, ¶ 84.

¹⁹⁰ *Amurta*, 2007 E.C.R. I-9569, ¶ 84.

¹⁹¹ See, e.g., *id.*

¹⁹² See Case C-319/02, *Manninen*, 2004 E.C.R. I-7477, ¶ 54.

¹⁹³ *Id.* A discrete question concerns whether the residence state also will relieve jurisdictional double taxation by crediting or otherwise relieving the source-based withholding on the dividend.

highly dependent upon the exact tax treatment in the corporation state.¹⁹⁴

A related problem with the court's jurisprudence concerns the conceptual difficulty of distinguishing the shareholder- and corporate-level taxes under an integrated tax system. The court's jurisprudence requires the source state to relieve economic double taxation only when it imposes such double tax itself, by taxing both the corporation and the foreign shareholder.¹⁹⁵ The court seems to assume that the tax on the corporation can be distinguished from the tax on the shareholder, even though the very purpose of corporate integration may be to assess a single, integrated tax on the corporate profits.

In all the cases considered so far by the court, however, the Member State itself distinguished between a corporate-level and a shareholder-level tax.¹⁹⁶ While the state may have maintained a distinction between these levels of tax purely for reasons of administrative simplicity, the court merely relied on distinctions already drawn by the state.¹⁹⁷ The maintenance by the states of a distinction between the corporate-level tax and the shareholder-level tax provides the basis for the distinction made by the ECJ between those two taxes. Therefore, by relying on that distinction, at least in the source country context where the same state levies both the corporate- and the shareholder-level taxes, the court has not introduced significant uncertainty or introduced a standard that relies on an artificial and in-administrable distinction between the corporate-level and shareholder-level taxes.

In contrast, this distinction is questionable from the perspective of the shareholder's residence state. In the case of inbound dividends, another Member State assessed the corporate-level tax, and that state may have drawn a different distinction between the shareholder-level and the corporate-level taxes than that drawn by the shareholder's

¹⁹⁴ See notes 125-26 and accompanying text. As this Section makes clear, while each state's obligation is conditional on the other state's treatment, the decision does not involve a perpetual circular analysis. Instead, a Member State can look once to the tax treatment in the other state to make a final determination of its own obligation. Thus, in light of *Amurta*, we would answer in the negative the following question posed by Graetz and Warren before *Amurta* was decided: "Does the combined logic of [Manninen and Denkavit Internationaal] create the possibility that the source country's obligations would depend on the residence country's resolution of its obligations, which would in turn depend on the source country's resolutions of its obligations, and so on?" Graetz & Warren, *Dividend Taxation*, note 127, at 1614.

¹⁹⁵ See text accompanying notes 138-41.

¹⁹⁶ See, e.g., Case C-292/04, *Meilicke v. Finanzamt Bonn-Innenstadt*, 2007 E.C.R. I-1835, ¶ 13; Case C-446/04, *Test Claimants in the FII Group Litig. v. Commissioners of Inland Revenue*, 2006 E.C.R. I-11753, ¶¶ 6-17.

¹⁹⁷ See, e.g., *Meilicke*, 2007 E.C.R. I-1835, ¶ 28; *FII Group Litig.*, 2006 E.C.R. I-11753, ¶¶ 47, 54.

residence state. For example, suppose the source state desired to tax corporate profits at an overall, integrated tax rate of 25%. Endless variations on corporate and shareholder-level taxes could achieve this result. The state could tax the corporation at 25% and the shareholder at zero, or the opposite. The state could split the corporate and shareholder-level taxes however it wanted. The residence state's obligation on inbound dividends in an imputation system depends, however, on the level of foreign corporate taxation. For example, in *Manninen and FII Group Litigation*, the ECJ held that the residence state was not required to provide more relief of economic double taxation on inbound dividends than on domestic dividends, and it could not provide less.¹⁹⁸ But assuming that the source state split the tax between the corporation and the shareholder, it is unclear how the residence state would determine which part of the tax represents the "corporate tax." Since the extent of the other Member State's burden to relieve economic double tax depends on the amount of "corporate tax" assessed by the source state, its obligation under EC law may turn on an untenable distinction between the corporate- and shareholder-level taxes in the source state. In addition, differences in how Member States define taxable income (that is, differences in tax base) may make it difficult to compare the level of tax assessed on corporate profits by two different Member States. Although the court acknowledged that determining the tax paid in the other Member State may be difficult, it also stated that those difficulties cannot justify a violation of the EC Treaty.¹⁹⁹

D. Dividend Taxation in Europe Today

In response to the cases just described, many Member States have adopted schedular systems, which do not require coordination between the corporate- and shareholder-level taxes to ensure that economic double taxation is not over- or under-relieved.²⁰⁰ Schedular

¹⁹⁸ See Subsection III.A.2.b.

¹⁹⁹ The court stated:

In those circumstances, the calculation of a tax credit granted to a shareholder fully taxable in Finland, who has received dividends from a company established in Sweden, must take account of the *tax actually paid* by the company established in that other Member State, as such tax arises from the general rules on calculating the basis of assessment and from the rate of corporation tax in that latter Member State. Possible difficulties in determining the tax actually paid cannot, in any event, justify an obstacle to the free movement of capital

Case C-319/02, *Manninen*, 2004 E.C.R. I-7477, ¶ 54 (emphasis added).

²⁰⁰ See, e.g., Eric Bjrengier, French Finance Bill Merits Corporate Attention, 32 Tax Notes Int'l 7 (Oct. 6, 2003); Outi Raitasuo, Working Group Recommends Tax Cuts, Revocation of Dividend Imputation, 29 Tax Notes Int'l 831 (Mar. 3, 2003) (dealing with Finnish

systems either employ a preferential rate on dividends, a reduced tax base, or a mix of those two approaches.²⁰¹ Under this method of relief, dividends received by individual shareholders are taxed as a separate category (“schedule”) of income, which allows states to set the corporate- and the shareholder-level taxes independently of each other, thereby alleviating the need to consider the tax rates of other Member States in cross-border dividend cases.

Only Ireland,²⁰² Romania,²⁰³ and Spain²⁰⁴ still take a classical approach to the taxation of corporate profits. Recall that the jurisprudence we have discussed does not affect classical tax systems because they do not involve selective relief of economic double taxation. Classical systems treat foreign and domestic shareholders the same: Both are fully subject to double economic tax. Since Ireland’s and Romania’s corporate tax rates are comparatively low, economic double taxation on Irish and Romanian-sourced dividends is likewise comparatively low. Some Member States—Greece, Estonia, and Latvia—completely exempt dividends from taxation at the shareholder level.²⁰⁵

taxation); Stefano Serbini & Paola Flora, Italy: New Dividend and Capital Gains Regime, 44 Eur. Tax’n 121, 123-26 (2004); Henk Vording & Allard O. Lubbers, The Netherlands Presumptive Income Tax on Portfolio Investment: Background, Aims and Effects, 60 Bull. Int’l Tax’n 327 (2006); Adam Zalasinski, New Dividend Taxation System in Poland, 47 Eur. Tax’n 201 (2007). Only Malta still employs imputation. See note 177.

²⁰¹ Austria, Belgium, Bulgaria, Czech Republic, Denmark, Hungary, Lithuania, Poland, Sweden, and Slovenia employ a preferential rate on dividends; Germany, Luxembourg, France, and Portugal employ a reduced tax base; Finland, Italy, and the Netherlands employ a mix of those two approaches. See Communication on Dividend Taxation, note 64, at 7-9; Zalasinski, note 200 (Poland); Bjrengier, note 200 (France); Ambroise Bricet, Tax Bills Bring Major Changes for Business, Shareholders, 33 Tax Notes Int’l 140, 141 (Jan. 12, 2004) (France); Serbini & Flora, note 200, at 123-26 (Italy); Philip Siekman & Nicolien Luijsterburg, Personal Income Taxation in the Netherlands, 60 Bull. Int’l Tax’n 316 (2006); Vording & Lubbers, note 200 (the Netherlands).

²⁰² See Communication on Dividend Taxation, note 64, at 8.

²⁰³ Romania applies a 16% gross withholding tax on distributions to resident individuals, which is equal to its normal 16% flat individual tax rate. See Romulus Badea, Romania, in Central/Eastern Europe—Taxation & Investment ¶ B.1.9.2 (IBFD ed., 2008). The Romanian withholding tax was lowered in 2009 to 10%. Government Emergency Ordinance No. 91 on the Amendment and Completion of Law No. 571/2003 Regarding the Fiscal Code (June 24, 2008), published in Official Gazette No. 480 (June 30, 2008).

²⁰⁴ See Carlos Palao, New Income Tax Law and Anti-Fraud Legislation in Spain, 61 Bull. Int’l Tax’n 139, 140-41 (2007) (detailing Spain’s move from imputation to classical taxation).

²⁰⁵ See Communication on Dividend Taxation, note 64, at 7-9. Estonian corporations pay corporate income tax at a rate of 22% when profits are distributed, not when earned, regardless of the residence of the shareholders. Thus, the main difference between the Estonian corporate tax and that of other countries is timing of tax liability. See Kofler, note 92, at 920; Helen Pahapill, Estonia Proposes Amendment to EU Parent-Subsidiary Directive, 37 Tax Notes Int’l 145 (Jan. 10, 2005); Robert Zukowski, Estonian Corporate Income Tax and the European Union: The Implications, 46 Eur. Tax’n 128, 128-30 (2006). In addition to the corporate income tax, Estonia assesses a separate withholding tax on

The situation is more uniform for intercorporate dividends. In purely domestic settings, the Member States, with the exception of Malta, exempt intercorporate dividends from the parent corporation's income. While some states grant the exemption without further conditions, others require a minimum holding percentage, a minimum holding period, and/or a minimum investment.²⁰⁶ Under the Parent-Subsidiary Directive, most cross-border intercorporate dividends are exempt both inbound and outbound. Many Member States, however, exempt cross-border intercorporate dividends only if they are required to do so under the Parent-Subsidiary Directive.²⁰⁷ It is unlikely that such differential treatment can be upheld.²⁰⁸ The ECJ invalidated such regimes in *Denkavit Internationaal* and *Amurta* for outbound dividends,²⁰⁹ and the Commission already has taken action in this matter against some Member States.²¹⁰

IV. U.S. CASE LAW ON STATE TAXATION OF DIVIDENDS IN A CROSS-BORDER CONTEXT

Issues similar to those raised in the international context also arise in the U.S. subnational state context, but on a more limited basis. There are several reasons for this, and to understand them, it is neces-

dividends paid to nonresident legal persons holding less than 20% of Estonian corporations. The European Commission views this as incompatible with Article 5(1) of the Parent-Subsidiary Directive. See Erki Uustalu, EU Accession and the Estonian Tax System, 43 Eur. Tax'n 162, 165 (2003). Nevertheless, Estonia "may . . . continue to apply that tax to profits distributed by Estonian subsidiaries to their parent companies established in other Member States" until December 31, 2008. Act Concerning the Conditions of Accession of the Czech Republic, the Republic of Estonia, the Republic of Cyprus, the Republic of Latvia, the Republic of Lithuania, the Republic of Hungary, the Republic of Malta, the Republic of Poland, the Republic of Slovenia and the Slovak Republic and the Adjustments to the Treaties on which the European Union Is Founded, 2003 O.J. (L 236) 816.

²⁰⁶ See Wim Eynatten, European Holding Company Tax Regimes: A Comparative Study, 47 Eur. Tax'n 562 (2007).

²⁰⁷ Applicability of the Directive depends on ownership thresholds and a holding period. See text accompanying note 68.

²⁰⁸ See Georg Kofler & Gerald Toifl, Austria's Differential Treatment of Domestic and Foreign Inter-Company Dividends Infringes the EU's Free Movement of Capital, 45 Eur. Tax'n 232 (2005).

²⁰⁹ See Section III.B.

²¹⁰ See, e.g., Press Release, European Comm'n, Direct Taxation: Commission Requests Belgium, Spain, Italy, Luxembourg, the Netherlands and Portugal to End Discriminatory Taxation of Outbound Dividends, IP/06/1060 (July 26, 2006); Press Release, European Comm'n, Direct Taxation: Commission Decides to Refer Belgium, Spain, Italy, the Netherlands and Portugal to the Court Over Discriminatory Taxation of Outbound Dividends and Asks Latvia to End Such Discriminatory Taxation, IP/07/66 (Jan. 22, 2007); Press Release, European Comm'n, Taxation of Outbound Dividends: Commission Takes Steps Against Austria, Germany, Italy and Finland, IP/07/1152 (July 23, 2007); Press Release, European Comm'n, Taxation of Outbound Dividends: Commission Takes Steps Against Germany, Estonia and the Czech Republic, IP/08/143 (Jan. 31, 2008).

sary to have at least a rudimentary understanding of state personal income taxation, state corporate income taxation, and the general treatment of dividends under both regimes.

A. U.S. State Taxation of Dividends

1. State Personal Income Taxation

a. Juridical Double Taxation of Dividends

States' taxation of personal income generally conforms to the international norm. Most states impose broad-based personal income taxes on all their residents' income wherever earned.²¹¹ To avoid juridical double taxation, all states with broad-based income taxes provide a credit for taxes paid by their residents to other states on income taxed by those states on a source basis.²¹² Moreover, states do not impose source-based withholding taxes on dividends or other passive income paid to nonresidents. An individual's dividends therefore are subject to tax on a source basis only in very unusual circumstances.²¹³ Even in those circumstances, the taxpayer's state of residence ordinarily will provide a credit for any tax imposed by the state of source. Accordingly, there is virtually no juridical double taxation of dividends under state personal income taxes.

b. Economic Double Taxation of Dividends

The almost universal starting point for determining an individual's state taxable income is the taxpayer's federally defined income.²¹⁴ Accordingly, an individual's state taxable income reflects the "classical" approach to taxation of corporate profits taken at the federal level. Individual state taxpayers therefore must report as personal income dividends reflecting income that has already been subject to state corporate income taxation.²¹⁵ While this economic double tax-

²¹¹ 2 Jerome R. Hellerstein & Walter Hellerstein, *State Taxation*, ¶ 20.04[2] (3d ed. 2000).

²¹² *Id.* These credits often do not apply to taxes paid to foreign countries, which appears to raise a substantial constitutional question of discrimination against foreign commerce. See *id.* ¶ 20.10[4].

²¹³ Such tax may occur when an individual taxpayer's corporate stock is used in a business or has acquired a "business situs" outside of his state of residence. *Id.* ¶ 20.05[6].

²¹⁴ The states make various adjustments to the individual federal tax base to arrive at state taxable income. 2 Hellerstein & Hellerstein, note 211, ¶ 20.02. Only seven states impose no personal income taxes. See note 219.

²¹⁵ The limited relief that the United States now provides from economic double taxation at the federal level by reducing the individual tax rate on qualified dividends to 15%, see note 20 and accompanying text, has no effect at the state level, where personal income tax rates never reach 15%. Even if they did, the states normally determine their tax rates independently of the federal tax rates.

tion may be objectionable as a matter of tax policy, it is a fact of fiscal life in the subnational U.S. context. Although selective relief from economic double taxation would likely raise serious constitutional questions, since U.S. states offer no relief from economic double taxation with respect to income reflected in dividends paid to individual shareholders, state taxation of individual shareholders has not given rise to such constitutional objections.²¹⁶

2. *State Corporate Income Taxes*

Unlike the states' personal income tax regimes, which generally conform to international norms, the state corporate income tax regimes differ substantially from their international counterparts. Understanding these differences is essential to understanding the issues of juridical and economic double taxation under state corporate income taxes.

a. *Juridical Double Taxation of Intercorporate Dividends*

As with individuals, the almost universal starting point for determining a corporation's state taxable income is the taxpayer's federally defined income.²¹⁷ After adjustments that generally relate to definitional as distinguished from jurisdictional concerns,²¹⁸ the federal adjusted tax base is then determined to be taxable within or without the state, based on rules that reflect both source and residence principles and federal constitutional restraints on state taxation.

To determine whether income is taxable within a particular state, the states generally divide a corporate taxpayer's adjusted federally defined tax base into "business income,"²¹⁹ and "nonbusiness in-

²¹⁶ There is no general federal constitutional prohibition on economic double taxation, because the states have a rational basis for taxing both corporations and their shareholders, as long as such economic double taxation is applied on an evenhanded basis to cross-border and domestic dividends. One state court, however, construed the state constitution as prohibiting economic double taxation of corporations under the state's business profits tax. See *First Fin. Group of N.H., Inc. v. State*, 430 A.2d 162, 165 (N.H. 1981).

²¹⁷ 1 Hellerstein & Hellerstein, note 211, ¶ 7.02 (corporate income).

²¹⁸ For example, the states may choose not to define the tax base in precisely the way that it is defined for federal tax purposes with respect to such items as depreciation and net operating loss carryforwards and carrybacks. See *id.* ¶¶ 7.10, 7.16.

²¹⁹ Unif. Div. of Income for Tax Purposes Act § 1(a), 7A U.L.A. 147 (2002). Of the forty-three states with broad-based corporate income taxes, 1 Research Inst. of Am., Inc. (RIA), All States Tax Guide ¶ 210 (2008) (chart), twenty-two states (as well as the District of Columbia) have adopted UDITPA. 7A U.L.A. at 141. Even those states that have not adopted UDITPA as such nevertheless have statutory schemes that closely resemble UDITPA. The only states without broad-based corporate net income taxes are Michigan, Nevada, Ohio, South Dakota, Texas, Washington, and Wyoming.

come.”²²⁰ Business income is defined as “income arising from transactions and activity in the regular course of the taxpayer’s trade or business”²²¹ Nonbusiness income is simply “all income other than business income.”²²² Business income is taxed on a source basis, and only on a source basis. The source of business income is determined by formulary apportionment; such income is divided among those states in which the taxpayer’s apportionment “factors” are located.²²³ Unlike apportionable business income, which typically is divided among many states, nonbusiness income typically is “allocated” to a specific state (or states).²²⁴ Although some allocation rules are source-based,²²⁵ other allocation rules (including those applicable to dividends) are residence-based.²²⁶

Dividends may constitute business income apportioned on a source basis or nonbusiness income allocated on a residence basis. Under the overriding constitutional principle that “the linchpin of apportionability in the field of state income taxation is the unitary business principle,”²²⁷ states may (and generally do) treat as apportionable business income dividends received from subsidiaries that constitute part of a single economically integrated or “unitary” business.²²⁸ Because federal constitutional restraints on multiple taxation of inter-

²²⁰ UDITPA § 1(e).

²²¹ UDITPA § 1(a).

²²² UDITPA § 1(e).

²²³ UDITPA provides: “All business income shall be apportioned to this state by multiplying the income by a fraction, the numerator of which is the property factor, plus the payroll factor, plus the sales factor, and the denominator of which is three.” UDITPA § 9. Although at one time almost all states with income taxes employed this standard, equally weighted, three-factor formula to apportion corporate net income, see *Moorman Mfg. Co. v. Bair*, 437 U.S. 267, 283 (1978) (Powell, J., dissenting) (forty-four of forty-five states use three-factor formula), today there are substantial variations in the number and weighting of the factors, with many states adopting either a single-factor sales formula or double-weighting the sales factor (while maintaining a three-factor formula). See CCH, *Multistate Corporate Income Tax Guide* ¶ 600-200 (2008) (chart). For a detailed consideration of the states’ use of formulary apportionment to determine the source of corporate income, see 1 Hellerstein & Hellerstein, note 211, chs. 8, 9.

²²⁴ UDITPA § 4.

²²⁵ See, e.g., UDITPA §§ 5, 6 (allocating nonbusiness rents and capital gains from real property to the state in which the property is located).

²²⁶ UDITPA § 7.

²²⁷ *Mobil Oil Corp. v. Commissioner of Taxes of Vt.*, 445 U.S. 425, 439 (1980).

²²⁸ See 1 Hellerstein & Hellerstein, note 211, ¶ 9.10[1][a]. The statement in the text assumes that the state in question takes a “separate-entity reporting” rather than a “combined reporting” approach to the treatment of dividends arising from a unitary business conducted with commonly controlled subsidiaries. For treatment of dividends in the combined or consolidated context, see *id.* ¶ 8.11. The use of formulary apportionment to determine the source of dividends constituting business income contrasts with the international norm of determining the source of dividends by reference to the distributing corporation’s state of residence. See note 27 and accompanying text.

state and foreign commerce²²⁹ preclude one state from allocating to itself on a residence basis dividends that other states properly may treat as apportionable on a source basis,²³⁰ intercorporate dividends in principle will not suffer juridical double taxation at the state level.

Portfolio dividends and other dividends arising from investments in corporations that are neither part of the taxpayer's unitary business nor serve an "operational function" in the taxpayer's unitary business generally are classified as "nonbusiness income"²³¹ and allocated to the taxpayer's commercial domicile.²³² Such residence-based taxation of portfolio and similar dividends creates no risk of juridical double taxation under the states' existing tax regimes, because the states' power to impose residence-based taxes is contingent on the absence of the power in other states to tax the dividends on a source basis by reference to the taxpayer's apportionment factors. Although such risk may still exist in principle because of the states' power to impose withholding taxes on a source basis (based on the dividend payor's rather than taxpayer-payee's apportionment factors),²³³ since no state cur-

²²⁹ See 1 Hellerstein & Hellerstein, note 211, ¶ 4.08[1] (interstate commerce), ¶ 4.19[1] (foreign commerce). The Constitution prohibits the states from taxing values unrelated to economic activity carried on within the state, and it prohibits states from burdening interstate and foreign commerce by subjecting it to the risk of multiple taxation. For an overview of the state statutory framework governing taxation of corporate income and its relationship to the constitutional restraints on such taxation, see Walter Hellerstein, *State Taxation of Corporate Income from Intangibles: Allied-Signal and Beyond*, 48 Tax L. Rev. 739, 743-55 (1993).

²³⁰ *Standard Oil Co. v. Peck*, 342 U.S. 382 (1952) (announcing principle that Constitution precludes taxpayer's state of domicile from taxing on a "residence" basis unapportioned value that another state could tax on a "source" basis); see *Mobil Oil Corp.*, 445 U.S. 425 (reaffirming that principle in a cross-border intercorporate dividend case).

²³¹ UDITPA §§ 1(a), 1(e); see also *MeadWestvaco ex rel. Mead Corp. v. Ill. Dep't of Revenue*, 128 S. Ct. 1498, 1508-09 (2008) (explicating the "operational function" criterion of apportionability); *Allied-Signal, Inc. v. Dir., Div. of Taxation*, 504 U.S. 768 (1992) (articulating the "operational function" criterion of apportionability). For a discussion of the "operational function" criterion of apportionability, see 1 Hellerstein & Hellerstein, note 211, ¶ 8.08[2][e][v]; Walter Hellerstein, *MeadWestvaco and the Scope of the Unitary Business Principle*, 108 J. Tax'n 261 (2008).

²³² UDITPA § 7.

²³³ Wisconsin once imposed a withholding tax on dividends paid to shareholders. The tax was measured by the proportion of the corporation's dividends that were attributable to Wisconsin, determined by reference to the corporation's income tax apportionment percentage. In *International Harvester Co. v. Wisconsin Department of Taxation*, 322 U.S. 435 (1944), the Supreme Court sustained the constitutionality of the tax as applied to a nonresident shareholder, observing, among other things, that "[p]ersonal presence within the state of the stockholders-taxpayers is not essential to the constitutional levy of a tax out of so much of the corporation's Wisconsin earnings as is attributable to them," *id.* at 441, and the fact that "some practical device [may] be necessary in order to enable the state to collect the tax—here by imposing on the corporation the duty to withhold," *id.* at 444, did not deprive the state of power to impose the tax on the nonresident shareholder.

rently imposes withholding taxes on passive income, this potentially troublesome problem is more theoretical than real.²³⁴

In short, because of overriding constitutional concerns, the relationship between the source and residence principles in the state corporate income tax context is markedly different from their relationship in the international tax context. In the international context, source and residence are overlapping jurisdictional bases that give rise to the risk of economic and juridical double taxation. In the state corporate income tax context, by contrast, because federal constitutional restraints on multiple taxation of interstate and foreign commerce inform the application of the source and residence rules, source and residence principles are alternative jurisdictional bases that largely eliminate juridical double taxation, at least as a matter of principle, and limit the risk of economic double taxation.

b. Economic Double Taxation of Intercorporate Dividends

Because the starting point for determining taxable income for state corporate income tax purposes is almost invariably the taxpayer's federal taxable income,²³⁵ the state corporate income tax base reflects federal rules designed to avoid economic double taxation at the federal level.²³⁶ Under the federal dividends received deduction (DRD), at least 70% of dividends received from another domestic corporation is deductible by the corporate shareholder.²³⁷ Dividends received from foreign corporations generally are not eligible for the DRD.

Although the states generally follow the federal intercorporate DRD rules, some states deviate from these rules in order to limit the DRD to dividends from income that the state has already taxed in the hands of the payor²³⁸ or to dividends paid by corporations that are

²³⁴ As one of the authors has noted elsewhere in discussing this problem, one easy solution to it would be the provision of a credit by the domiciliary state for any withholding tax paid on a source basis to other states. Hellerstein, note 211, at 822-23 n.440.

²³⁵ 1 Hellerstein & Hellerstein, note 211, ¶ 7.02.

²³⁶ See id. ¶ 7.07 (treatment of dividends); RIA, State and Local Taxes ¶ 11,046 (2008) (for each state).

²³⁷ IRC § 243. The percentage of the dividend that is deductible rises with the stock ownership of the corporate shareholder, so that while only 70% of the dividend is deductible to an owner of less than 20% of the stock of the payor, 100% of the dividend is deductible to an owner of at least 80% of the payor. Id. The term "domestic corporation," as used in the Code, refers to a corporation created or organized in the United States or under the law of the United States or any state or territory. IRC § 7701(a)(4).

²³⁸ See, e.g., Cal. Rev. & Tax. Code § 24402 (West 2001), invalidated by Farmer Bros. Co. v. Franchise Tax Bd., 134 Cal. Rptr. 2d 390 (Ct. App. 2003) (deduction for dividends permitted only if the dividends are paid out of income that was included in the measure of the payor's California franchise or income tax); La. Rev. Stat. Ann. § 47:287.73(B)(3), amended by 2005 La. Acts. 401 (deductions for dividends permitted to the extent that the

taxable by the state.²³⁹ This selective relief of economic double taxation has given rise to the case law that we discuss below.²⁴⁰

B. DRD Confined to Income Previously Taxed by the State

Contemporary controversies involving U.S. state taxation of cross-border dividends are concerned almost exclusively with corporate-level taxes and do not concern individual shareholder taxes. Disputes have arisen primarily in two contexts: (1) when the states have modified the basic federal rules for relieving economic double taxation of corporate income to distinguish between cross-border and “domestic” dividends,²⁴¹ and (2) when they have distinguished between dividends from U.S. subsidiaries and dividends from non-U.S. subsidiaries. Although there is, as yet, no EU analogue for the latter category of cases, we discuss them briefly in anticipation of rulings by the ECJ interpreting the applicability of the freedom of establishment to dividends involving non-EU Member States, so called “third countries.”²⁴²

Some states deviate from the federal DRD in order to limit the deduction to dividends from income that the state has already taxed in the hands of the payor or to dividends paid by corporations that are taxable by the state.²⁴³ There are sound policy reasons, at least from a state’s wholly internal perspective, for deviating from the federal DRD rules. In deducting from the tax base dividends received from other domestic (U.S.) corporations, Congress sought to avoid economic double taxation of the same underlying corporate earnings, in view of the fact that the earnings of the payor, as a domestic corporation, had already been taxed once under the federal income tax. That

dividends were earned in Louisiana and the income from which such dividends were paid has been taxed in the state).

²³⁹ See Ala. Code § 40-18-35, amended by 2008 Ala. Legis. Serv. 543 (West) (deduction for dividends permitted only when payor is subject to tax in Alabama); former Ariz. Rev. Stat. Ann. § 43-1128, repealed by 2002 Ariz. Sess. Laws, ch. 50, § 6 (deduction for dividends from less-than-50% owned corporations permitted only when payor’s principal business or 50% or more of its income is in Arizona); R.I. Gen. Laws § 44-11-12(1)(ii) (2008) (excluding dividends from “[a]ny corporation liable to a tax imposed by this chapter”); cf. Mo. Ann. Stat. § 143.431(2) (West 2008) (allowing deduction, “to the extent included in federal taxable income, [for] corporate dividends from sources within Missouri”).

²⁴⁰ See Section IV.C.

²⁴¹ See notes 245, 254, and accompanying text. Our use of the term “domestic” dividends in the U.S. context differs somewhat from the definition in the EU context where we defined “domestic” dividends as dividends paid by a resident corporation to a resident shareholder. In the U.S. context, a “domestic” dividend is more accurately described simply as a dividend reflecting income that already has been taxed by the shareholder’s state to the dividend payor. See Section III.B.

²⁴² See EC Treaty, note 51, art. 56; discussion in Section IV.B.

²⁴³ See notes 238–40 and accompanying text.

principle is not applicable—at least in its entirety—to state taxation, because the dividend-paying corporation may not be subject to tax in the dividend recipient's state, or if the payor was taxable there, the state may have taxed only a small fraction of the payor's income if it was apportioned or allocated largely outside the state.

As logical as these limitations may appear from the standpoint of state tax policy, they raise serious Commerce Clause objections. On its face, a DRD limited to dividends reflecting income already taxed by the state, or received from corporations that are taxable by the state, favors investment in in-state over out-of-state economic activity. As most state courts reviewing these provisions have recognized, such provisions are impossible to reconcile with the Supreme Court's decisions barring state taxes that discriminate against interstate commerce by providing preferential treatment to in-state over out-of-state activities.²⁴⁴

1. Constitutional Challenges

In the first case to address the constitutionality of a DRD limited to dividends reflecting income earned in the state, the California Court of Appeal considered a DRD for dividends received from insurance companies that was "limited to that portion of the dividends received which are determined to be paid from income from California sources."²⁴⁵ The limitation plainly favored investment in dividend-paying insurance companies engaged in in-state income-producing activity over similar companies engaged in out-of-state income-producing activity because the greater the percentage of the insurance companies' in-state income-producing activities, the greater the percentage of their dividends that were eligible for the DRD. Accordingly, the limitation appeared vulnerable to the "virtually per se rule

²⁴⁴ See, e.g., *Fulton Corp. v. Faulkner*, 516 U.S. 325, 346 (1996) (striking down intangible property tax that applied to corporate stock only to the extent that the issuing corporation engaged in out-of-state activity); *Maryland v. Louisiana*, 451 U.S. 725, 755-59 (1981) (invalidating "first use" tax on natural gas brought into state because of credits favoring investment in in-state over out-of-state mineral exploitation). We should be clear that in this portion of the Article we simply describe existing Commerce Clause doctrine, and do not defend it. Whether the Commerce Clause should be read to bar discrimination in favor of in-state over out-of-state investment (as distinguished from discrimination in favor of in-state products over out-of-state products, or in-state persons over out-of-state persons) is another question. See generally *Graetz & Warren*, *Income Tax Discrimination*, note 127, at 1236-44 (arguing that Commerce Clause should not be so construed); cf. *Graetz & Warren*, *Dividend Taxation*, note 127 (questioning tax policy reflected in ECJ decisions).

²⁴⁵ *Ceridian Corp. v. Franchise Tax Bd.*, 102 Cal. Rptr. 2d 611, 615 n.2 (Ct. App. 2000) (quoting former Cal. Rev. & Tax. Code § 24410).

of invalidity”²⁴⁶ for taxes that discriminate on their face against interstate commerce by favoring in-state over out-of-state investment.²⁴⁷

2. State’s Defenses

The California Franchise Tax Board defended the restrictive DRD “as a valid means of avoiding double taxation.”²⁴⁸ The court rejected the proposition that the state’s legitimate interest in preventing economic double taxation was a defense to a substantiated claim of Commerce Clause discrimination.²⁴⁹ Thus, the court declared that “the parties’ debate about [whether the DRD] does or does not prevent double taxation misses the mark.”²⁵⁰ The issue was “not whether [the DRD] serves some legitimate purpose, but whether it survives a commerce clause challenge.”²⁵¹

The Franchise Tax Board further contended that, rather than discriminating, the tax merely “level[ed] the playing field between corporate taxpayers receiving dividends from insurance companies” that were subject to tax in California because they were doing business there and those receiving dividends from insurance companies that were exempt from tax in California because they did no business there.²⁵² The court found unpersuasive the Board’s comparison of (1) the aggregate in-state tax liability of both the dividend recipient and the dividend payor when both do business in the state with (2) the tax liability of the dividend recipient alone when the payor does no business in the state.²⁵³

The controlling authority was the Supreme Court’s decision in *Fulton Corp. v. Faulkner*.²⁵⁴ In *Fulton*, the Court considered a North Carolina intangible property tax as applied to taxpayers who owned corporate stock.²⁵⁵ The value of the stock assessed under the tax,

²⁴⁶ *City of Philadelphia v. New Jersey*, 437 U.S. 617, 624 (1978).

²⁴⁷ See note 244; see generally 1 Hellerstein & Hellerstein, note 211, ¶¶ 4.13, 4.13[1][a].

²⁴⁸ *Ceridian*, 102 Cal. Rptr. 2d at 617.

²⁴⁹ *Id.* at 619.

²⁵⁰ *Id.* at 617.

²⁵¹ *Id.*

²⁵² *Id.*

²⁵³ *Id.* In this connection, it is important to keep in mind that California did not “combine” the income of the dividend payor and the dividend payee, thereby eliminating the dividends as an intercorporate item, and taxing the income of both payor and payee on an enterprise basis. See notes 245, 259-60, and accompanying text. Rather, the “aggregate” argument set forth in the text was one that in form continued to respect the separate tax liabilities of the separately reporting taxpayers but in practice lumped them together as a matter of economic substance. We explore the validity of this type of comparison for purpose of determining the existence of Commerce Clause discrimination in more detail below. See notes 254-64 and accompanying text.

²⁵⁴ 516 U.S. 325 (1996).

²⁵⁵ *Id.* at 327.

however, was reduced by a percentage equal to the percentage of the corporation's income subject to tax in North Carolina.²⁵⁶ Under this regime, the stock of a corporation doing all of its business in North Carolina would be subject to no intangible tax; the stock of a corporation doing none of its business in North Carolina would be subject to tax on 100% of its value.²⁵⁷ The Court had no hesitation in branding North Carolina's taxing scheme as facially discriminatory.²⁵⁸

The California court found that this analysis compelled the conclusion that California's DRD was likewise discriminatory.²⁵⁹ As in *Fulton*, the state imposed a tax based on value derived from ownership of a corporation, and “[j]ust as North Carolina reduced its intangibles tax in direct proportion to the amount of business the owned corporation did within the state's borders, so too California reduces the dividend tax to the extent such dividends are ‘paid from income from California sources.’”²⁶⁰ *Fulton* prohibited such tax favoritism for in-state economic activity.²⁶¹

Subsequent cases construing California's general DRD for dividends that have been included in California income at the corporate level²⁶² followed the reasoning of the insurance company case and found the DRD unconstitutionally discriminatory. The vice of the DRD was that it favored dividend-paying corporations doing business in California and paying California taxes over dividend-paying corporations doing no business in California and paying no taxes there and thus “discriminate[d] between transactions on the basis of an interstate element, which is facially discriminatory under the commerce clause.”²⁶³

A third line of argument potentially provided a defense for the limited DRD, namely, the complementary tax doctrine.²⁶⁴ This doctrine

²⁵⁶ *Id.* at 327-28.

²⁵⁷ *Id.* at 328.

²⁵⁸ *Id.* at 333 (“A regime that taxes stock only to the degree that its issuing corporation participates in interstate commerce favors domestic corporations over their foreign competitors in raising capital among North Carolina residents and tends, at least, to discourage domestic corporations from plying their trades in interstate commerce.”).

²⁵⁹ *Ceridian Corp. v. Franchise Tax Bd.*, 102 Cal. Rptr. 2d 611, 620 (Ct. App. 2000).

²⁶⁰ *Id.* (citation omitted).

²⁶¹ See *Fulton Corp. v. Faulkner*, 516 U.S. 325, 333 (1996).

²⁶² The California statute required the dividend to be paid out of income “included in the measure” of other California taxes for it to be eligible for the DRD. Cal. Rev. & Tax. Code § 24402 (1998) (amended 2000).

²⁶³ *Farmer Bros. Co. v. Franchise Tax Bd.*, 134 Cal. Rptr. 2d 390, 398 (Ct. App. 2003), cert. denied, 540 U.S. 1178 (2004); accord *Gen. Motors Corp. v. Franchise Tax Bd.*, 16 Cal. Rptr. 3d 41 (Ct. App. 2004), aff'd in part and rev'd in part on other grounds, 139 P.3d 1183 (Cal. 2006).

²⁶⁴ To avoid confusion with “compensatory” taxes imposed in the shareholder imputation credit situation, such as that imposed by Finland and described in note 199 and accompanying text, we describe this doctrine as the “complementary” tax doctrine, although the

protects an apparently discriminatory state tax from attack when the state can identify a “complementary” exaction that cures the apparent discrimination.²⁶⁵ It is analogous to the fiscal cohesion defense in ECJ case law.²⁶⁶

In its contemporary opinions, the Court has distilled the teachings of its complementary tax cases into a three-pronged inquiry for determining whether the doctrine applies. First, the state must identify the intrastate tax burden for which the state is attempting to compensate by levying a tax on interstate commerce. Second, the tax on interstate commerce must be shown roughly to approximate, but not exceed, the amount of the complementary tax on intrastate commerce. Third, the events on which the interstate and intrastate taxes are imposed must be ‘substantially equivalent’; that is, they must be sufficiently similar in substance to serve as mutually exclusive ‘prox[ies]’ for each other.”²⁶⁷

In cases arising in North Dakota and California, the states argued that confining DRDs to income derived from sources within the state merely complemented the tax imposed on the profits of the in-state dividend payor.²⁶⁸ The North Dakota Supreme Court rejected this argument because the state failed the first prong of the complementary tax inquiry: North Dakota failed to identify any specific in-state activity or benefit conferred on the recipient of dividends from an out-of-state corporation that would justify a complementary levy on the dividends.²⁶⁹ The California courts found that the California DRD failed to satisfy any of the three prongs of the complementary tax doctrine.²⁷⁰ First, the California courts were unable to identify an intrastate activity or benefit that would justify taxing the recipient’s cross-border dividends.²⁷¹ Second, there was no showing that the tax on the cross-border dividends approximated an equivalent tax on intrastate

U.S. cases and literature refer to it interchangeably as the “complementary” or “compensatory” tax doctrine.

²⁶⁵ The paradigmatic example of complementary taxes are sales and use taxes. Even though a use tax discriminates on its face against interstate commerce because it applies principally to goods purchased outside the state for use within the state, it is nevertheless constitutional because it “complements” sales taxes that would have applied to goods purchased in the state. See generally 1 Hellerstein & Hellerstein, note 211, ¶ 4.13[2][c]; Walter Hellerstein, *Complementary Taxes as a Defense to Unconstitutional State Tax Discrimination*, 39 Tax Law. 405 (1986).

²⁶⁶ See notes 111-16 and accompanying text.

²⁶⁷ *Or. Waste Sys., Inc. v. Dep’t of Envtl. Quality*, 511 U.S. 93, 103 (1994) (alteration in original) (citation omitted); see also *Fulton Corp. v. Faulkner*, 516 U.S. 325, 331 (1996); *Associated Indus. of Mo. v. Lohman*, 511 U.S. 641, 647-48 (1994).

²⁶⁸ See *Gen. Motors*, 16 Cal. Rptr. 3d at 57-58; *Farmer Bros.*, 134 Cal. Rptr. 2d at 400-01; *D.D.I., Inc. v. State ex rel. Clayburgh*, 657 N.W.2d 228, 233 (N.D. 2003).

²⁶⁹ *D.D.I.*, 657 N.W.2d at 234.

²⁷⁰ *Gen. Motors*, 16 Cal. Rptr. 3d at 58; *Farmer Bros.*, 134 Cal. Rptr. 2d at 400-03.

²⁷¹ *Gen. Motors*, 16 Cal. Rptr. 3d at 58; *Farmer Bros.*, 134 Cal. Rptr. 2d at 400-01.

commerce.²⁷² Third, the events on which the two complementary taxes were purportedly imposed—the dividend payment, in one case, and the dividend receipt, in the other—were not substantially equivalent.²⁷³

3. *Internal Consistency*

There is an additional doctrinal strain in the U.S. case law involving restrictive DRDs that is especially worthy of note because of its contrast with the EU case law, namely, the “internal consistency” doctrine.²⁷⁴ The “internal consistency” doctrine requires that a state tax impose no greater burden on interstate commerce than on intrastate commerce on the hypothetical assumption that every state has adopted the tax regime under consideration. Several of the cases invalidating DRDs that relieved only intrastate economic double taxation invoked the internal consistency doctrine, which focuses on the risks of multiple taxation to which other states might expose the income in question, regardless of whether other states actually taxed such income.

For example, in rejecting the state tax commissioner’s defense of a DRD confined to economic double taxation occurring wholly within the state’s borders, one court observed that this “ignores the corporate income tax that an out-of-state corporation’s state might impose on the out-of-state corporation’s profits, which effectively imposes a double layer of tax on the out-of-state income but not on the in-state income.”²⁷⁵ The court noted that the internal consistency doctrine “looks at the structure of the challenged tax to see whether its identical application by every state would place interstate commerce at a disadvantage against intrastate commerce.”²⁷⁶ The DRD flunked the internal consistency test because, when the effect of out-of-state corporate income tax paid was considered, dividends from out-of-state profits were still subject to double taxation, whereas double tax was relieved on dividends from in-state profits.²⁷⁷ The persistence of eco-

²⁷² *Gen. Motors*, 16 Cal. Rptr. 3d at 58; *Farmer Bros.*, 134 Cal. Rptr. 2d at 401-02.

²⁷³ *Gen. Motors*, 16 Cal. Rptr. 3d at 58; *Farmer Bros.*, 134 Cal. Rptr. 2d at 403; *Ceridian Corp. v. Franchise Tax Bd.*, 102 Cal. Rptr. 2d 611, 619 (Ct. App. 2000).

²⁷⁴ See generally Ruth Mason, *Made in America for European Tax: The Internal Consistency Test*, 49 B.C. L. Rev. 1277 (2008); Walter Hellerstein, *Is “Internal Consistency” Dead?: Reflections on an Evolving Commerce Clause Restraint on State Taxation*, 61 Tax L. Rev. 1 (2007); Walter Hellerstein, *Is “Internal Consistency” Foolish?: Reflections on an Emerging Commerce Clause Restraint on State Taxation*, 87 Mich. L. Rev. 138 (1988).

²⁷⁵ *D.D.I., Inc. v. State ex rel. Clayburgh*, 657 N.W.2d 228, 234 (N.D. 2003); see also *Farmer Bros.*, 134 Cal. Rptr. 2d at 400.

²⁷⁶ *D.D.I.*, 657 N.W.2d at 234.

²⁷⁷ *Id.*; see also *Farmer Bros.*, 134 Cal. Rptr. 2d at 400.

nomic double taxation on interstate commerce placed it at a disadvantage compared with in-state commerce.

4. *Foreign Dividends, Combined Reporting, and General Electric*

In contrast to the uniform holdings of other state courts on the issue, the New Hampshire Supreme Court, in *General Electric Co. v. Commissioner*,²⁷⁸ rejected Commerce Clause objections to a DRD limited to dividends reflecting income that was already subject to tax in the hands of the dividend payors. New Hampshire included dividends from certain unitary non-U.S. subsidiaries (hereafter simply “foreign dividends”) in a New Hampshire taxpayer’s apportionable income.²⁷⁹ While including the foreign dividends in income, New Hampshire provided the taxpayer a DRD equal to the amount of New Hampshire income previously taxed to the distributing foreign subsidiary.²⁸⁰ In this respect, the New Hampshire taxing scheme appeared to resemble closely the California and North Dakota DRDs invalidated by courts in those states,²⁸¹ albeit limited to foreign subsidiaries. The New Hampshire Supreme Court, however, refused to follow the reasoning of the state court opinions described above in large part because it believed that the case raised an issue different from that addressed by those courts. Rather than focusing on the taxpayer’s basic contention that the New Hampshire scheme discriminated against foreign commerce because the DRD was confined to dividends received from foreign subsidiaries doing business in New Hampshire, the court instead characterized the issue before it as one involving an examination of New Hampshire’s “taxing regime as a whole”²⁸² and “the aggregate tax assessed against the unitary business in New Hampshire,”²⁸³ taking account of the tax liability of *both* the dividend payor *and* the dividend payee.

Although the California and North Dakota court decisions had examined and rejected this “aggregate” approach, the New Hampshire court relied on state court decisions that had taken the aggregate approach in the superficially analogous, but conceptually distinct, context of *combined* reporting regimes. Many states have adopted

²⁷⁸ *Gen. Elec. Co. v. Commissioner*, 914 A.2d 246 (N.H. 2006), cert. denied, 128 S. Ct. 529 (2007). In the interest of full disclosure, it should be noted that Walter Hellerstein was one of the counsel representing the taxpayer in this case. The views expressed here, however, are those of the authors and do not necessarily reflect the views of General Electric Company.

²⁷⁹ *Id.* at 249.

²⁸⁰ *Id.* at 250.

²⁸¹ See Section IV.B.

²⁸² *Gen. Elec.*, 914 A.2d at 257.

²⁸³ *Id.* at 259.

combined reporting regimes under which the income of a parent and the income of its unitary subsidiaries are combined, with intercompany transactions eliminated.²⁸⁴ Since combination eliminates intra-group dividends from income, intra-group dividends are not taxed to the receiving company. Because unitary foreign subsidiaries are generally excluded from combined reporting, dividends from such subsidiaries typically are included in the apportionable tax base.

Taxpayers have challenged the inclusion of foreign dividends from unitary subsidiaries in a taxpayer's apportionable tax base at the same time that domestic dividends are eliminated in the combined report as a discrimination against foreign commerce in violation of the Commerce Clause. State courts addressing this issue generally have rejected taxpayers' attacks.²⁸⁵ For example, the Kansas Supreme Court examined "the aggregate tax" that Kansas imposed on a unitary business with a U.S. subsidiary, which filed on a combined basis, with the "aggregate tax" that Kansas imposed on a unitary business with a non-U.S. subsidiary.²⁸⁶ The court concluded that the former "would not be less burdensome" than the latter "because the income of the [U.S.] subsidiary would be combined, apportioned, and taxed while only the dividend of the [non-U.S.] subsidiary would be taxed."²⁸⁷

The New Hampshire court did not focus on the critical fact that the New Hampshire case did *not* involve a combined report. Hence it did not involve a comparison between a domestic subsidiary whose dividend was eliminated as part of the subsidiary's inclusion in the combined report and a separately reporting foreign subsidiary. Instead, *General Electric* involved a stark comparison of the differential treatment of separately filing foreign subsidiaries depending on whether they conducted business in the state.

Without dwelling on this distinction, however, the *General Electric* court simply followed the combined reporting cases and characterized the issue before it as one involving "the aggregate tax assessed against the unitary business in New Hampshire."²⁸⁸ Under this approach, the court rejected the claim of discrimination because the "aggregate" tax on the non-U.S. subsidiary itself and on the dividends it paid to the combined group would be greater (even with the DRD) when the sub-

²⁸⁴ See *Container Corp. of Am. v. Franchise Tax Bd.*, 463 U.S. 159, 165 (1983); 1 Hellerstein & Hellerstein, note 219, ¶ 8.11.

²⁸⁵ *Caterpillar Fin. Servs. Corp. v. Whitley*, 680 N.E.2d 1082, 1088 (Ill. App. Ct. 1997); *In re Morton Thiokol, Inc.*, 864 P.2d 1175 (Kan. 1993); *E.I. Du Pont de Nemours & Co. v. State Tax Assessor*, 675 A.2d 82 (Md. 1996); *Caterpillar, Inc. v. Commissioner of Revenue*, 568 N.W.2d 695, 701 (Minn. 1997).

²⁸⁶ *Morton Thiokol*, 864 P.2d at 1186.

²⁸⁷ *Id.*

²⁸⁸ *Gen. Elec.*, 914 A.2d at 259.

sidiary conducted business and generated taxable income in the state than when it did not conduct business in the state.²⁸⁹

The U.S. Supreme Court refused to review the case,²⁹⁰ thus leaving the New Hampshire decision intact, and, in the case of allegedly discriminatory DRDs, leaving the law regarding discriminatory DRDs in the United States in a state of considerable confusion. While the New Hampshire decision suggests that a DRD limited to dividends reflecting previously taxed income is constitutionally acceptable, the decisions of courts in California, North Dakota, and other states suggest just the opposite. Consequently, unless and until either the Supreme Court or Congress resolves this controversy, the uncertainty over the constitutionality of a DRD conditioned on the in-state activity of the dividend payor will persist.

V. COMPARATIVE ANALYSIS

If the foregoing discussion has accomplished nothing else, it demonstrates beyond peradventure that selective taxation of cross-border dividends by individual states enjoying substantial tax sovereignty within an overarching constitutional framework designed to create a common market raises difficult issues. At the most basic level, these issues are simply a reflection of the conflict between the states' interest in exercising their taxing powers in ways that respond to their internal concerns and the competing interests of economic unity demanded by the broader constitutional polity of which they are members. Taking this underlying conflict as a common starting point, in this part we provide a comparative analysis of the responses of the constitutional courts in the European Union and the United States to selective corporate tax integration. As we noted at the outset of this Article, discrete constitutional frameworks, dissimilar taxing regimes, different levels of government, and disparate factual contexts render any effort to compare EU and U.S. judicial pronouncements perilous at best.²⁹¹ With these caveats in mind, we nevertheless believe that exploration of the responses of the ECJ and the U.S. courts to the common problem of selective taxation of dividends is illuminating.

²⁸⁹ *Id.* at 257.

²⁹⁰ *Gen. Elec. Co. v. Commissioner*, 128 S. Ct. 529 (2007).

²⁹¹ Cf. Hellerstein & McLure, note 4 (making analogous point with regard to relevance of U.S. experience to European Commission's proposal for a common consolidated corporate tax base).

A. Conflict Between State Tax Sovereignty and Economic Union

The U.S. and EU cases discussed in this Article present the same fundamental problem. The states taxed both corporations and their shareholders on corporate profits, leading to economic double taxation. Some states viewed distortions created by economic double taxation as undesirable, so they took various steps, loosely falling under the rubric of corporate integration, to reduce or eliminate the problem. They did so entirely from the perspective of their internal tax regimes, without regard to the tax regimes of other states in their union or to the constitutional restraints imposed by membership in that union. As a result, the states almost invariably limited economic double tax relief to cases in which they had collected both the corporate-level and the shareholder-level tax.

The foregoing narrative is not surprising. Even for member states of political unions, tax sovereignty tends to be exercised without regard to the tax regimes in other states. Indeed, cognizant of the importance of retaining control over their taxes, neither the EU states nor the U.S. states explicitly surrendered any direct tax authority when they formed their respective unions. Although the EU states have agreed to exacting constraints on the exercise of their indirect tax powers,²⁹² and although the U.S. Constitution bars the states from imposing “any Imposts or Duties on Imports or Exports,”²⁹³ nothing in either foundational document expressly limits the states’ direct tax powers. This retention of tax autonomy was an essential part of the initial constitutional understandings. Two provisions of the EC Treaty assure the states substantial control over taxation. First, legislative actions affecting taxation require the unanimous approval of the Member States, which effectively grants each Member State veto power over EC tax legislation.²⁹⁴ Second, the principle of subsidiarity directs that no decision should be made at the EU level that can better be made by Member States.²⁹⁵

²⁹² See Ben J.M. Terra & Peter J. Wattel, *European Tax Law* 30 (5th ed. 2008).

²⁹³ U.S. Const. art. I, § 10, cl. 2 (the Import-Export Clause). The only other explicit prohibition on state taxation in the U.S. Constitution is a related, but much narrower limitation, prohibiting a “Duty of Tonnage.” *Id.* art. I, § 10, cl. 3. “A duty of tonnage within the meaning of the Constitution is a charge upon a vessel, according to its tonnage, as an instrument of commerce, for entering or leaving a port, or navigating the public waters of the country.” *Huse v. Glover*, 119 U.S. 543, 549-50 (1886).

²⁹⁴ EC Treaty, note 51, art. 94. Although there is now the possibility of the adoption of tax legislation through the so-called “enhanced cooperation” procedure requiring only a “qualified majority,” as an historical matter (and to a large extent even today), the unanimity requirement of Article 100 assures a substantial degree of state tax sovereignty. See *id.* art. 100.

²⁹⁵ See *id.* art. 5.

Likewise, the Tenth Amendment to the U.S. Constitution (adopted shortly after the Constitution itself), “reserve[s]” powers not delegated to the federal government “to the States . . . or to the people,”²⁹⁶ and thus provides contextual support for the states’ retention of their tax sovereignty. This bland constitutional text, however, does not fully reflect the strong tradition of state tax sovereignty embodied in longstanding political and constitutional understandings. As the U.S. Supreme Court has repeatedly acknowledged, the states’ power of taxation is essential to their independent existence and thus to the federal scheme that the framers created.²⁹⁷ For example, Chief Justice Marshall observed in 1824 that the states’ “power of taxation is indispensable to their existence. . . .”²⁹⁸ Fifty years later, the Court echoed these sentiments when it declared that “the taxing power of a State is one of its attributes of sovereignty; that it exists independently of the Constitution of the United States.”²⁹⁹ The Court has reiterated these views in modern opinions.³⁰⁰

Consequently, in both the European Union and the United States, the states’ tax autonomy is central to their very identity as sovereign states within the confines of a political and economic union. Indeed, it is interesting to contrast the states’ original and continuing autonomy in tax matters with the centralized exercise of other economic powers by their respective unions, including with regard to currency,³⁰¹ trade, antitrust, intellectual property, pollution, and many other matters. Al-

²⁹⁶ U.S. Const. amend. X.

²⁹⁷ Writing in *The Federalist* in 1788, Alexander Hamilton declared that “the individual States should possess an independent and uncontrollable authority to raise their own revenues for the supply of their own wants” and that “an attempt on the part of the national Government to abridge them in the exercise of it would be a violent assumption of power unwarranted by any article or clause of its Constitution.” *The Federalist No. 32*, at 181 (Alexander Hamilton) (Bantam Dell 1982).

²⁹⁸ *Gibbons v. Ogden*, 22 U.S. 1, 199 (1824); see also *Weston v. City of Charleston*, 27 U.S. 449, 466 (1829) (“The power of taxation is one of the most essential to a state, and one of the most extensive in its operation.”).

²⁹⁹ *Railroad Co. v. Peniston*, 85 U.S. 5, 29 (1873).

³⁰⁰ “When dealing with their proper domestic concerns, and not trenching upon the prerogatives of the National Government or violating the guaranties of the Federal Constitution, the States have the attribute of sovereign powers in devising their fiscal systems to ensure revenue and foster their local interests.” *Allied Stores of Ohio, Inc. v. Bowers*, 358 U.S. 522, 526 (1959).

³⁰¹ Dramatically, fifteen of the EU Member States have adopted the euro as their common currency, including Austria, Belgium, Cyprus, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Malta, the Netherlands, Portugal, Slovenia, and Spain. European Comm’n, http://ec.europa.eu/economy_finance/the_euro/index_en.htm (last visited Mar. 1, 2009). Slovakia joined them on January 1, 2009. Commission Welcomes Council Approval of Slovakia’s Euro Adoption (July 8, 2008), available at <http://ec.europa.eu/rapid/press-ReleasesAction.do?reference=ip/08/1113&format=HTML&aged=08&language=EN&gui-Language=en>. The U.S. Constitution granted to Congress the power “[t]o coin Money” and “regulate the Value thereof.” U.S. Const. art. I, § 8, cl. 5.

though the European Union has adopted a few directives to achieve harmonization in direct tax matters,³⁰² and the U.S. Congress has occasionally imposed national rules affecting direct taxation,³⁰³ the EU and U.S. states have largely been left to their own devices regarding direct taxation. To be sure, the U.S. states have effectively ceded a portion of their tax sovereignty to the federal government by adopting the federal tax base as the state tax base. Nevertheless, they remain free to deviate from that base at any time.³⁰⁴ Because there is no analogue to the U.S. federal tax base in the European Union, this type of voluntary harmonization, with its attendant loss of tax sovereignty, has not been an option in the European Union, although the Member States are currently exploring a common consolidated corporate tax base.³⁰⁵

International tax law and practice tend to reinforce the view that the states are free to act independently in tax matters. For example, the U.S. states generally are not subject to the constraints of double tax treaties entered into by the U.S. federal government,³⁰⁶ although they are subject to the nondiscrimination article of U.S. tax treaties.³⁰⁷ Thus, to the extent that tax treaty nondiscrimination articles are interpreted to preclude differential taxation of foreign (non-U.S.) dividends, that restriction also would apply to the U.S. states.³⁰⁸ As noted at the outset of this Article, however, tax treaties generally do not require extension of domestic economic double tax relief to dividends from treaty partners. In the absence of any international consensus

³⁰² See, e.g., discussion of the Parent-Subsidiary Directive notes 68-70 and accompanying text. Another symposium article discusses a proposal for an elective harmonized corporate tax regime in the European Union. See Jack Mintz & Joann M. Weiner, Some Open Negotiation Issues Involving a Common Consolidated Corporate Tax Base in the European Union, 62 Tax L. Rev. 81 (2008).

³⁰³ Public Law 86-272, which limits the states' power to tax income that an out-of-state vendor derives from sales into a state when the vendor's only activities in the state are the solicitation of orders for tangible personal property, is the most significant piece of federal legislation restricting state taxing authority. 15 U.S.C. §§ 381-384 (2006). Cf. Kathryn L. Moore, State and Local Taxation: When Will Congress Intervene?, 23 J. Legis. 171, 204 (1997) (giving reasons for Congress' reluctance to intervene in state taxes).

³⁰⁴ States tend to deviate from the federal base when the federal government adopts base changes that threaten the states' fiscal stability. See 1 Hellerstein & Hellerstein, note 211, ¶ 7.02[1][a] (describing state "decoupling" from federal model in response to changes in federal depreciation rules).

³⁰⁵ See note 71 and accompanying text.

³⁰⁶ Container Corp. of Am. v. Franchise Tax Bd., 463 U.S. 159, 196 (1983) ("[T]he tax treaties into which the United States has entered do not generally cover the taxing activities of subnational governmental units such as States . . .").

³⁰⁷ United States Model Income Tax Convention arts. 2, 24 (Nov. 15, 2006), available at <http://www.ustreas.gov/press/releases/reports/hp16801.pdf> [hereinafter U.S. Model Treaty]

³⁰⁸ The nondiscrimination article of the U.S. Model Treaty applies "to taxes of every kind and description imposed by a Contracting State or a political subdivision or local authority thereof." Id. art. 24, ¶ 7.

regarding the duty to extend such relief to treaty partners, it is not terribly surprising that the U.S. states and the EU Member States did not adopt more liberal rules for dividends from fellow members of their economic unions.

Political and economic unions such as the European Union and the United States, however, spawn nondiscrimination rules embodying principles of locational neutrality that are more robust than those embodied in international tax principles. These nondiscrimination rules create a profound tension with the states' parochial approach to corporate tax integration. The cases discussed in Parts III and IV illustrate the judicial effort to resolve the conflict between the desire for unhindered economic integration within the union and the states' conceptualization of their sovereign tax powers as complete and independent of those of the other members of the common market. As a general proposition, it is clear from the EU and U.S. case law that the nondiscrimination principles in the EC Treaty and the U.S. Constitution significantly cabin the autonomy of the constituent states to implement tax schemes that distort locational investment decisions by preferring in-state to out-of-state activity.³⁰⁹ In the next section, we refine and elaborate upon this general proposition, examining similarities and differences in the articulation of these nondiscrimination principles and identifying, insofar as the case law permits, a common conception of the restraints on state tax autonomy to effectuate corporate tax integration.

B. Comparing Constitutional Constraints

In this Section, we pose the questions common to both unions concerning selective corporate tax integration and explore the answers that have emerged from the jurisprudence in each one.

1. Must States Extend Integration to Inter-Market Dividends?

Courts in both regimes addressed the constitutionality of laws providing relief from dividend tax at the shareholder level but only when the dividend had been taxed by the relieving state at the corporate level.³¹⁰ The common question in these cases was whether selective relief of double taxation discriminated against inbound dividends in violation of the constitutional restraints imposed by the respective common market principles.³¹¹ Perhaps the single most important

³⁰⁹ See notes 127-30, 306-08 and accompanying text.

³¹⁰ See, e.g., Sections III, IV.

³¹¹ We use the term "inbound dividend" advisedly here, because it is no more than shorthand for the true comparison in the EU and U.S. contexts. The key in both cases is

“comparative” conclusion that emerges from the EU and U.S. case law is that courts from both regimes answer this question in the same way—namely, “yes”: If the taxing state provides economic double tax relief to domestic dividends, then it must, at least in certain circumstances, provide equivalent relief to “inbound” dividends.³¹² The conclusion is significant because it demonstrates that common market concerns of economic freedom and undistorted competition may override a state’s tax policy interest in limiting economic double taxation relief to double tax created by its own taxing regime. A state that is part of a common market therefore cannot provide for relief of economic double taxation in the purely domestic context without regard to the implications of that relief for cross-border trade.

The reasons for this limitation emerge in tandem from the EU and U.S. case law. In concluding that, in some circumstances, failure to extend economic double tax relief to inbound dividends constitutes discrimination within the meaning of overriding common market principles, courts from both regimes have embraced a concept of discrimination that goes beyond traditional international law concepts of nationality-based discrimination and product-based discrimination to include a notion of investment neutrality that precludes favoring in-state over out-of-state investment.³¹³ Indeed, the ECJ’s opinion in *Verkooijen*³¹⁴ and the Supreme Court’s opinion in *Fulton*³¹⁵ are doctrinal twins. In *Verkooijen*, the ECJ held that the practice of limiting dividend exemption to domestic dividends violated the freedom of capital movement because it “dissuaded” Dutch residents from investing in companies established in other Member States and restricted the ability of such companies to raise capital in the Netherlands because it treated dividends from those companies less favorably than dividends from Dutch companies.³¹⁶ In *Fulton*, the Court declared: “A regime that taxes stock only to the degree that its issuing corpora-

that the underlying income reflecting the dividend has not been taxed (or has been taxed only in part) by the shareholder’s state, and the relief from the shareholder tax is granted only to the extent that such income has not already been subjected to tax. This ordinarily will be true with respect to an “inbound” dividend from a foreign corporation without a permanent establishment or constitutional “nexus” in the state; however, in the U.S. sub-national context, the same issue would arise if the dividend payor were subject to tax in the state of the shareholder, but paid a tax on only a portion of the income reflected in the dividend.

³¹² See note 105 and accompanying text (EU cases); note 278 and accompanying text (U.S. cases).

³¹³ See, e.g., Alvin C. Warren, Jr., *Income Tax Discrimination Against International Commerce*, 54 Tax L. Rev. 131, 166 (2001); Graetz & Warren, *Income Tax Discrimination*, note 127, at 1253.

³¹⁴ Case C-35/98, *Staatssecretaris van Financiën v. Verkooijen*, 2000 E.C.R. I-4071.

³¹⁵ *Fulton Corp. v. Faulkner*, 516 U.S. 325 (1996).

³¹⁶ *Verkooijen*, 2000 E.C.R. I-4071, ¶¶ 32, 34-35.

tion participates in interstate commerce favors domestic corporations over their foreign competitors in raising capital among North Carolina residents and tends, at least, to discourage domestic corporations from plying their trades in interstate commerce.”³¹⁷

This reasoning shows that in both jurisdictions, the principal concern is that states should not use their tax systems to create preferences for intra-state over intra-union commerce. Courts in neither union considered the tax policy question of whether economic double taxation should be relieved. Under both the U.S. Constitution and the EC Treaty, the choice of whether to relieve economic double taxation is left to the states, but once the states elect to provide such relief domestically, they cannot categorically withhold relief from cross-border dividends.

2. *May Absence of Domestic Corporate-Level Tax Justify Selective Relief?*

The EU and U.S. cases also share common views regarding the persuasiveness of the EU and U.S. states’ defenses to their tax regimes, which were themselves remarkably similar. For example, recall the “fiscal cohesion” justification raised in the European context, under which the shareholder’s residence state argues that since only domestic dividends are subject to a risk of economic double taxation, relief should apply only to domestic dividends.³¹⁸ From a purely single-state perspective, the state argues that it collects two taxes on domestic dividends (one from the corporation and one from the shareholder) but only one tax on inbound dividends (from the shareholder). From this limited perspective, domestic dividends appear to be taxed more heavily than inbound dividends, and relieving economic double taxation at the shareholder level would merely place domestic and inbound dividends at tax parity. If relief also were extended to inbound dividends, the state would collect no tax whatsoever on inbound dividends.

This fiscal cohesion defense is mirrored by the “avoidance of double taxation,” “no discrimination in the aggregate,” and “complementary tax” defenses in the U.S. context.³¹⁹ Like EU Member States, U.S. states argued that limiting the DRD to domestic dividends was neces-

³¹⁷ *Fulton*, 516 U.S. at 333. Although *Fulton* involved selective relief from double taxation of corporate stock and corporate income from such stock rather than double economic taxation of two income streams, the analysis was equally applicable to relief from economic double taxation of income, and the case law invalidating state DRDs limited to dividends reflecting income previously taxed by the state relies squarely on *Fulton*. See notes 254-61 and accompanying text.

³¹⁸ See notes 111-14 and accompanying text.

³¹⁹ See notes 248-67 and accompanying text.

sary to level the playing field between domestic dividends, which were paid out of profits already taxed to the corporation by the state, and inbound dividends, which were paid out of profits not taxed to the corporation by the state.³²⁰ Since the shareholder's residence state did not by itself subject the corporate profits to economic double taxation, it should not have to grant economic double tax relief.

This parochial, single-state perspective is unsurprising, if ultimately indefensible in a common market context. Because both the EU and U.S. states were accustomed to thinking about economic double taxation issues through the lens of unfettered state tax sovereignty, rather than as common market issues informed by Community or Commerce Clause strictures, their failure to extend double taxation relief to cross-border dividends, even if discriminatory, was hardly "invidious."

Nevertheless, and tellingly, the EU and U.S. courts generally rejected these defenses and for similar reasons. First, and most fundamentally, courts in both regimes concluded that the demands of their respective common markets precluded a defense that ignored the consequences of the relief from economic double taxation for cross-border investment. This does not mean that the courts necessarily required examination of other states' tax regimes for determining the validity of the regime under consideration, an issue to which we return, and regarding which the EU and U.S. courts' approaches are somewhat different.³²¹ It does mean, however, that both the EU and U.S. jurisprudence rejected defenses that took no account of the relative attractiveness of in-state and cross-border investment that might result from their treatment of dividends, even if such treatment might be regarded as "neutral" from a wholly internal standpoint. In short, the demands of a common market involving other states left no room for a defense that failed to heed fellow states and the tax-induced incentives for in-state over out-of-state investment.

3. May Other Legitimate State Interests Justify Selective Relief?

With regard to other defenses offered by the states, the EU and U.S. courts found states' domestic tax policy goals outweighed by the community interests in economic unity. The EU cases hold that the objectives of stimulating in-state investment, reducing economic double taxation, and revenue concerns were simply insufficient to overcome the union's interest in preventing locational distortions caused by refusal to extend such relief to cross-border investments.³²²

³²⁰ *Ceridian Corp. v. Franchise Tax Bd.*, 102 Cal. Rptr. 2d 611, 617 (Ct. App. 2000); see also notes 245-64 and accompanying text.

³²¹ See Subsection V.B.5.

³²² See notes 109-23 and accompanying text.

Similarly, as the California court bluntly put it, the issue was “not whether [the DRD] serves some legitimate purpose,” but whether the tax favored in-state over out-of-state investment,³²³ which the court (along with others) held that it did.³²⁴ Thus far, in neither jurisdiction have states been able to justify discriminatory selective economic tax relief.

4. Can the Shareholder Tax Be Distinguished from the Corporate Tax Under an Integrated Tax System?

Insofar as the tax regimes at issue were based on separate entity reporting that respected the separate legal identities and separate taxes imposed upon the dividend recipient and the dividend payor,³²⁵ the jurisprudence in both the European Union and the United States generally held the respective states to that choice and did not allow them to treat the tax on the payor and payee as essentially a single integrated levy. Thus the ECJ case law rejected the defense that one should consider the tax on the shareholder and the corporation as in substance a single tax, because there was no “direct link” between the shareholder and the corporate level tax, each of which was imposed on and collected from a different legal entity.³²⁶ Similarly, the U.S. case law explicitly rejected the notion that the tax on the shareholder’s dividends and the tax on the dividend payor’s income could be regarded as “substantially equivalent” allowing them to be viewed as “sufficiently similar in substance to service as mutually exclusive ‘proxies’ for each other.”³²⁷

5. Do Fellow States’ Taxes Matter?

Courts in both jurisdictions rejected the argument that the shareholder states could limit economic double tax relief created when it assessed both levels of tax. The interests in economic unity and in preventing locational distortions required that the states take a broader outlook that considered the possibility that a fellow state taxed the corporate profits.³²⁸ But notwithstanding the significant

³²³ *Ceridian*, 102 Cal. Rptr. 2d at 617.

³²⁴ *Id.* at 618.

³²⁵ We note that this would not be the case with combined reporting regimes in the U.S. context. See notes 284-87 and accompanying text.

³²⁶ See, e.g., Case C-315/02, *Lenz v. Finanzlandesdirektion für Tirol*, 2004 E.C.R. I-7063, ¶¶ 38-53; Case C-35/98, *Staatssecretaris van Financiën v. Verkooijen*, 2000 E.C.R. I-4071, ¶¶ 55-62; see also notes 111-16 and accompanying text.

³²⁷ *Ceridian*, 102 Cal. Rptr. 2d at 618; see notes 245-64 and accompanying text.

³²⁸ For the European Union, see Subsection III.A.2.b; for the United States, see Section IV.A.

conceptual similarity between the EU and U.S. jurisprudence, the courts approached this issue very differently. Indeed, perhaps the most significant difference between the two sets of jurisprudence is the nature of the inquiry into other states' tax regimes and how taxes in the other state bear on the defendant state's constitutional obligations.

The focus in the EU jurisprudence on the actual burden imposed on domestic dividends taking account of actual tax regimes in other states contrasts with the U.S. Commerce Clause jurisprudence, which forbids taxes that create a risk of double taxation, regardless of whether they in fact result in double taxation. Thus, in articulating the restraints that the Commerce Clause imposes on state tax power, the Supreme Court has condemned taxes that expose interstate commerce to a "risk of a double tax burden to which intrastate commerce is not exposed."³²⁹ Similarly, in another case the Court held that the risk of double taxation was sufficient to establish a constitutional violation, even in the absence of actual double taxation, because "[a]ny other rule would mean that the constitutionality of West Virginia's tax laws would depend on the shifting complexities of the tax codes of 49 other States, and that the validity of the taxes imposed on each taxpayer would depend on the particular other States in which it operated."³³⁰ The Supreme Court's "internal consistency" doctrine³³¹ likewise takes the view that it is the risk rather than the actuality of double taxation that is the touchstone of constitutionality. The Supreme Court's approach thus contrasts with the ECJ's willingness, at least in some instances, to look at how other states actually tax the income in question, and to condition the Member States' constitutional obligations on other states' actual taxation.

There are also important doctrinal variations between the EU and the U.S. jurisprudence that arise from the precise context in which the constitutional issues arise. As explained in detail in Part IV, for example, the U.S. case law adjudicating constitutional challenges to inclusion of foreign dividends and exclusion of domestic dividends from water's edge combined reporting regimes cannot easily be compared, let alone reconciled with the EU jurisprudence described above, because of the contextual differences and the doctrinal distinctions that arise from those differences. Likewise, the various mechanisms for corporate tax integration adopted by the EU states in the cases described in Part III and their interaction with other Member States' tax

³²⁹ *J.D. Adams Mfg. Co. v. Storen*, 304 U.S. 307, 311 (1938); accord *Gwin, White & Henneford, Inc. v. Henneford*, 305 U.S. 434 (1939).

³³⁰ *Armco, Inc v. Hardesty*, 467 U.S. 638, 644-45 (1984).

³³¹ See Subsection IV.B.3.

regimes bear no close resemblance to the U.S. subnational tax regimes, which makes meaningful comparison of the results of the cases difficult if not impossible.

Finally, we cannot overlook the internal disarray in the EU and U.S. case law itself. Although we have done our best to distill the case law, our descriptions of the EU case law as "woefully complex"³³² and the U.S. case law as "in a state of considerable confusion"³³³ are probably understatements. Hence our efforts to extract common principles from the "tangled underbrush"³³⁴ of the case law on cross-border dividends legitimately may be regarded with some skepticism.

VI. CONCLUSION

Observers have long recognized that the principles for dividing tax jurisdiction among the states rely on the assumption of classical economic double taxation.³³⁵ In integrated corporate tax systems, those principles break down, resulting in unrelieved economic double taxation for cross-border, but not domestic, dividends. No uniform international tax solution accommodates the adoption of integrated corporate tax systems by most modern economies. While not providing a fully articulated solution to this problem, the ECJ in its cross-border dividends cases has at least made clear that levying double taxation on cross-border, but not domestic dividends, is inconsistent with the principles underlying the common market. The U.S. case law generally arrives at the same conclusion.

The prominent role taken by the EU and U.S. constitutional courts in adjudicating cases involving taxation of cross-border dividends raises the fundamental question of the appropriate judicial role in this area. While the states continue to enjoy the ability to determine whether to integrate corporate and shareholder taxes, the courts have identified significant countervailing interests in cross-border investment neutrality that restrain the exercise of tax sovereignty in the context of an economic union. As a practical matter, the restraints imposed by the ECJ on states' ability to limit double taxation relief to domestic dividends means that shareholder imputation, long used by EU countries to provide economic double tax relief, is probably no longer feasible for use in Europe. Although the ECJ's rulings do not specify how a Member State should reconcile its common market obligations with the domestic policy goal of integrating corporate and shareholder taxes, most countries that had shareholder imputation

³³² See text accompanying note 93.

³³³ See text following note 290.

³³⁴ *Nw. States Portland Cement Co. v. Minnesota*, 358 U.S. 450, 457 (1959).

³³⁵ See generally Ault, note 30.

systems in Europe simply repealed them in anticipation of or response to the Court's recent decisions.³³⁶

In light of the difficulties of coordinating shareholder imputation with international tax rules built for classical tax systems, the movement away from imputation may have happened even without the ECJ's intervention. The difficulty of coordinating the corporate tax, the shareholder tax, and the amount of the credit in cases where these three elements are not all controlled by a single state makes imputation ill-suited for cross-border dividends. Other countries, not parties to the EC Treaty, have also considered moving away from imputation in recent years.³³⁷ Nevertheless, the prominent role taken by the ECJ in determining the taxation of dividends is highly unusual when compared with other countries, in which decisions concerning relief from economic double taxation are motivated by legislative judgments of efficiency, equity, and administrability.

Looking beyond the United States and European Union, the notion that cross-border dividends should be excluded from economic double tax relief could be on the wane. For example, commentators have suggested that national court judges, particularly those in the European Union, might be tempted to interpret the OECD nondiscrimination principle in light of the ECJ nondiscrimination approach.³³⁸ The OECD has also announced its intention to consider fundamental revisions to the tax treaty concept of nondiscrimination in light of EC law developments.³³⁹ Thus, the ECJ's expansive view of nondiscrimination, as a collateral effect, could broaden the international law conception of nondiscrimination, and the cases decided by the ECJ and by U.S. courts in the common market context could serve as a guide to the treatment of cross-border dividends in an increasingly economically interdependent world.

³³⁶ See notes 175-80 and accompanying text.

³³⁷ See C. John Taylor, Approximating Capital-Export Neutrality in Imputation Systems: Proposal for a Limited Exemption Approach, 57 Bull. Int'l Fisc. Doc. 135 (2003) (discussing Singapore's repeal of its imputation system in favor of dividend exemption and Australia's reexamination of its imputation system, which ultimately ended in a decision to retain imputation, despite its problems in the cross-border context).

³³⁸ See, e.g., Mary C. Bennett, The David R. Tillinghast Lecture, Nondiscrimination in International Tax Law: A Concept in Search of a Principle (Oct. 22, 2005), in 59 Tax L. Rev. 439, 484-85 (2006).

³³⁹ OECD, Comm. on Fiscal Affairs, Working Party No. 1 on Tax Conventions and Related Questions, Application and Interpretation of Article 24 (Non-Discrimination), Public Discussion Draft (May 3, 2007), available at <http://www.oecd.org/dataoecd/59/30/38516170.pdf> (listing "possible impact of European Community Law on Article 24" as an issue requiring "a more fundamental analysis of the issue of non-discrimination and taxation which could lead to changes to Article 24").