DOUBLE TAXATION: A EUROPEAN "SWITCH IN TIME?"

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This article considers whether the fundamental freedoms of the EC Treaty encompass an absolute requirement for the Member States to mitigate juridical double taxation, and it concludes that such a requirement could reasonably be inferred from the goals of the fundamental freedoms and the European Court of Justice's "double burden" jurisprudence. Notwithstanding the reasonableness of that interpretation, in the recent Kerckhaert & Morres *case, the Court of Justice seems to have held that juridical double taxation does not violate the EC Treaty, even though double taxation distorts the Internal Market. We review the history of the Court's relevant jurisprudence, consider whether the Court has left any room for future rulings proscribing juridical double tax, and compare the treatment of double state taxation in the United States by the Supreme Court under the dormant Commerce Clause.*

I. INTRODUCTION

With twenty-seven countries and over 450 million inhabitants, the European Union is the largest common market in the world. But how well integrated is the European common market from a direct tax perspective? While indirect taxes have been harmonized in the EU for some time, direct taxes remain primarily the province

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of the individual Member States, and progress made in the income tax area has largely resulted from decisions of the European Court of Justice (ECJ).[1] Since the mid-1980s, EU taxpayers have aggressively litigated for enforcement of the fundamental freedoms of the EC Treaty on direct tax issues.[2] The ECJ has consistently interpreted the freedoms to prohibit tax discrimination—harsher tax treatment of cross-border economic activities than purely internal activities. For example, a Member State may not impose a higher tax rate on companies established in a fellow Member State than on domestic companies.[3] The Court of Justice has invalidated a variety of common international tax practices because they restrict EU nationals' ability to conduct trade or business across Member State borders, including controlled foreign corporation regimes,[4] limitation of group loss relief to domestic companies,[5] limitation of economic double tax relief to domestic dividends,[6] and thin capitalization rules.[7] But questions remain about one of the most persistent problems facing cross-border economic actors: juridical double taxation.

International public law imposes few limits on countries' tax powers other than the requirement of jurisdictional nexus.[8] In the absence of a general international law prohibition of double taxation, cross-border economic activities may be exposed to double or even multiple juridical income taxation.[9] Double taxation of cross-border business and investment occurs when both the investor's home state (usually referred to as the residence state) and the state where the investment is made (the source state) assert a right to tax the same item of income. For example, suppose a company resident for tax purposes in the United Kingdom opened a branch of operations in France. France, as the source state, would assert a right to tax the profits, since France provided the conditions necessary to earn the income, including

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[1] Although the distinction between direct and indirect taxation is imperfect, "[i]n general, taxes on individuals and corporations—income tax, wealth tax, corporate income tax, capital gains tax, etc.—are regarded as direct taxes, while taxes on goods or transactions—consumption taxes, stamp duties, etc.—are considered indirect." PAUL FARMER & RICHARD LYAL, EC TAX LAW 3 (1994).

[2] *See* Single European Act, art. 13, Feb. 17, 1986, 1987 O.J. (L 169) 1; The Consolidated Version of the Treaty Establishing the European Community, art. 39 (movement of workers), *id.* arts. 43, 48 (establishment), *id.* art. 49 (services), *id.* arts. 56, 58 (capital), Dec. 29, 2006, 2006 O.J. (C 321) E/1 [hereinafter EC Treaty].

[3] *See, e.g.*, Case C-311/97, Royal Bank of Scotland plc v. Greece, 1997 E.C.R. I-2651 (holding that imposition by Greece of higher tax rates on foreign banks than domestic banks violated the foreign bank's freedom to establish operations in Greece). *See generally* RUTH MASON, PRIMER ON DIRECT TAXATION IN THE EUROPEAN UNION (2005) [hereinafter MASON, PRIMER].

[4] Case C-196/04, Cadbury Schweppes plc v. Comm'rs of Inland Revenue, 2006 E.C.R. I-7995.

[5] Case C-446/03, Marks & Spencer plc v. Halsey, 2006 E.C.R. I-10837.

[6] *See, e.g.*, Case C-319/02, Manninen, 2004 E.C.R. I-7477.

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

[8] *See* Sjoerd Douma, *The Three Ds of Direct Tax Jurisdiction: Disparity, Discrimination and Double Taxation*, 46 EUR. TAX'N 522, 523 (2006).

[9] *See* Moris Lehner, *Das Territorialitätsprinzip im Licht des Europarechts*, *in* KÖRPERSCHAFTSTEUER – INTERNATIONALES STEUERRECHT – DOPPELBESTEUERUNG FESTSCHRIFT FÜR FRANZ WASSERMEYER 491 (Rudolf Gocke et al. eds., 2005). The OECD defines "international juridical double taxation" as "the imposition of comparable taxes in two (or more) States on the same taxpayer in respect of the same subject matter and for identical periods." *OECD Introduction to the OECD Model Tax Convention and Commentary*, ¶ 1, *reprinted in* 1 MATERIALS ON INTERNATIONAL & EC TAX LAW 45 (Kees van Raad ed., 2006). For brevity, we use the term "juridical double taxation" or simply "double taxation."

public services, infrastructure, a court system, and so on. But the United Kingdom may also assert a right to tax the branch profits; after all, the branch is part of a legal entity resident for tax purposes in the United Kingdom, and international practice recognizes that a state may tax its residents on all their income, wherever earned. In addition to taxing foreign income of its tax residents in order to raise revenue, the United Kingdom may consider taxing the foreign profits of its residents to be necessary to achieve efficiency and horizontal equity in its domestic tax regime. If the United Kingdom taxes the profits of British, but not foreign, branches, then British companies will have an incentive to set up branches in foreign countries with lower tax rates than the United Kingdom. Lower tax for foreign operations might also be perceived as unfair to British taxpayers with only domestic operations.[10]

Without either a bilateral double tax convention or a mechanism in domestic law to reduce double taxation unilaterally, the same profits may be taxed twice: once by the source state and once by the residence state. Even when countries adopt bilateral and unilateral mechanisms to mitigate the harsh effects of double taxation, taxpayers may still be subject to double taxation in a variety of contexts.[11] The principal question for this Article is whether the EC Treaty requires double taxation to be eliminated within the European Union.

The network of bilateral tax conventions for avoiding double taxation in the international tax context also serves as the primary mechanism for avoiding double taxation in the Community.[12] Tax treaties and the EC Treaty have been called "natural friends, because they pursue mutual objectives," such as reducing impediments to cross-border economic activity.[13] Moreover, abolition of double taxation is a clear goal of the EC Treaty,[14] since tax overlaps lead to distortions of the Internal Market.[15] However, because bilateral treaties do not cover every transaction in the Internal Market, it has not been possible to completely eliminate double taxation through tax treaties.[16] For example, although the network of tax

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[10] The United States imposes worldwide taxation on income earned by its residents abroad, while granting a credit for foreign taxes paid. I.R.C. §§ 61(a), 901–906. This method attempts to ensure that the decision whether to invest domestically or abroad is not motivated principally by the availability of lower tax rates in foreign countries, a policy known as capital export neutrality. For more on the justifications for source and residence taxation, see, e.g., Peggy B. Musgrave, *Sovereignty, Entitlement, and Cooperation in International Taxation*, 26 BROOK. J. INT'L L. 1335, 1343 (2001).

[11] *See infra* notes 16 to 18 and accompanying text.

[12] One could imagine EC legislation governing juridical double tax relief, and there is some limited double tax relief legislation in the EU. *See* references in *infra* note 86. However, the primary mechanisms for double tax relief within the Community remain unilateral provisions in domestic law and tax treaties.

[13] ERIC KEMMEREN, PRINCIPLE OF ORIGIN IN TAX CONVENTIONS 246 (2001).

[14] Case C-336/96, Gilly v. Directeur des Services Fiscaux du Bas-Rhin, 1998 E.C.R. I-2793, ¶ 16; Case C-265/04, Bouanich, 2006 E.C.R. I-923, ¶ 49. *See also* Case C-376/03, D. v. Inspecteur van de Belastingdienst, 2005 E.C.R. I-5821, ¶ 78 (Oct. 26, 2004) (opinion of Advocate General Ruiz-Jarabo Colomer).

[15] *See* Discussion Paper for the Informal Meeting of ECOFIN Ministers, *Taxation in the European Union*, SEC (96) 487, at 7. *See also* Gijs Fibbe & Arnaud de Graaf, *Is Double Taxation Arising from Autonomous Tax Classification of Foreign Entities Incompatible with EC Law?*, *in* A TAX GLOBALIST: ESSAYS IN HONOUR OF MAARTEN J. ELLIS 237 (Henk van Arendonk et al. eds., 2005).

[16] *Commission Communication to Parliament and the Council, Guidelines on Company Taxation*, SEC (90) 601 final (Apr. 20, 1990), ¶ 10.

treaties between Member States is nearly comprehensive,[17] and many countries grant relief unilaterally, juridical double taxation still occurs in the Community due to diverging interpretations of treaty provisions by the contracting Member States. Additionally, bilateral tax treaties have trouble dealing with triangular and multi-angular tax situations—situations involving three or more countries.[18] The inadequacy of tax treaties raises the question of whether Community law offers taxpayers a direct solution to double taxation. The question of whether the EC Treaty provides direct relief of double taxation has been called one of "today's trickiest issues concerning the scope of the prohibition of national tax practices based on the fundamental freedoms."[19]

Article 293 of the EC Treaty urges Member States, "so far as is necessary, [to] enter into negotiations with each other with a view to securing for the benefit of their nationals… the abolition of double taxation within the Community." But the ECJ has repeatedly made clear that Article 293 EC has no direct effect; it does not grant rights to individual taxpayers.[20] No serious objection to this conclusion has been raised in legal scholarship.[21] However, double taxation may violate provisions of the EC Treaty other than Article 293.[22] The EC Treaty prohibits Member States from erecting obstacles to intra-Community economic activities, and according to Advocate General Ruiz-Jarabo Colomer, "the fact that a taxable event might be taxed twice is the most serious obstacle there can be to people and their capital crossing internal borders."[23] Thus, it is possible that the EC Treaty could require relief of double taxation within the Community, even where no bilateral tax treaty or domestic law provides such relief.

In Part II of this Article, we analyze whether the fundamental freedoms protect EU nationals from juridical double taxation in the Community, and we conclude that a reasonable interpretation of the EC Treaty and the ECJ's relevant non-tax

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[17] The treaty network between the 15 "old" Member States was recently completed so that 102 bilateral treaties and the multilateral Nordic treaty cover all 105 possible bilateral relations between the 15 States. Since the accession of 10 Member States in mid-2004, and Bulgaria and Romania in 2007, 336 of the possible 351 bilateral relations are covered by treaties in force. *See* GEORG KOFLER, DOPPELBESTEUERUNGSABKOMMEN UND EUROPÄISCHES GEMEINSCHAFTSRECHT 158–159 (2007) [hereinafter KOFLER, DOPPELBESTEUERUNGSABKOMMEN].

[18] *See* Ruth Mason, *U.S. Tax Treaty Policy and the European Court of Justice*, 59 TAX LAW REV. 65, 110–115 (2005) [hereinafter Mason, *U.S. Tax Treaty Policy*]. Conflicts among the contracting states about how to classify income for treaty purposes also result in double taxation. *See id.* Likewise, conflicts concerning the legal person to whom income should be attributed result in double taxation. *See* Fibbe & de Graaf, *supra* note 15, at 237.

[19] Luc Hinnekens, *AMID: The Wrong Bridge or a Bridge Too Far? An Analysis of a Recent Decision of the European Court of Justice*, 41 EUR. TAX'N 206, 208 (2001).

[20] Case 137/84, Mutsch, 1985 E.C.R. 2681, ¶ 11 (concerning the first indent of Article 293 EC); Case C-398/92, Mund & Fester, 1994 E.C.R. I-467, ¶ 11 (concerning the fourth indent of Article 293 EC); Case C-336/96, Gilly v. Directeur des Services Fiscaux du Bas-Rhin, 1998 E.C.R. I-2793, ¶ 15 (concerning the second indent of Article 293 EC).

[21] *See* SERVAAS VAN THIEL, FREE MOVEMENT OF PERSONS AND INCOME TAX LAW: THE EUROPEAN COURT IN SEARCH OF PRINCIPLES 133 (2002) [hereinafter VAN THIEL, FREE MOVEMENT].

[22] *But see* Malcolm Gammie, *Double Taxation, Bilateral Treaties and the Fundamental Freedoms of the EC Treaty*, *in* A TAX GLOBALIST: ESSAYS IN HONOUR OF MAARTEN J. ELLIS 266, 278 (Henk van Arendonk et al. eds., 2005).

[23] Case C-376/03, D. v. Inspecteur van de Belastingdienst, 2005 E.C.R. I-5821, ¶ 85 (Oct. 26, 2004) (opinion of Advocate General Ruiz-Jarabo Colomer).

jurisprudence suggests that there is such protection. Notwithstanding that a right to relief of double taxation could reasonably be grounded in the fundamental freedoms, the ECJ recently ruled in the *Kerckhaert & Morres* case that a Member State was not required to grant relief for double taxation. We closely analyze that case and argue that it does not provide a final resolution to the double tax question. We also consider the impact a ban on double taxation would have on the Member States, focusing in particular on the question of which state—source or residence—would have the primary obligation to grant relief.

Finally, in Part III, we compare the ECJ's method of analysis in *Kerckhaert & Morres* to the U.S. Supreme Court's approach to analyzing double state taxation under the dormant Commerce Clause. We argue that had the legal regime at issue in *Kerckhaert & Morres* been subject to the Supreme Court's "internal consistency" test, it would not have passed constitutional muster. Thus, while we find that neither the Supreme Court nor the ECJ interprets the free trade provisions of the U.S. Constitution or EC Treaty to be an absolute bar on double taxation, after *Kerckhaert & Morres*, it appears that there is more protection from double state taxation in the U.S. common market than in the European common market.

II. JURIDICAL DOUBLE TAXATION AND THE FUNDAMENTAL FREEDOMS

A. EC Legal Background

The ECJ usually finds a violation of EC law whenever a Member State imposes a tax disadvantage on cross-border taxpayers that is not suffered by similarly situated domestic taxpayers.[24] The disadvantage might entail the imposition of harsher tax treatment for non-residents than similarly-situated residents. For example, in *Royal Bank of Scotland*, the ECJ found that Greece violated the freedom of establishment when it taxed Greek banks at 35%, but branches of foreign banks at 40%.[25] The disadvantage might also entail preferential treatment for residents that is not available to similarly-situated non-residents. For example, in *Imperial Chemical Industries*, the ECJ held that it was contrary to the freedom of establishment for the United Kingdom to deny group loss relief to a British group solely because a majority of its subsidiaries were established in other countries.[26] In those cases, it was relatively clear that a particular state imposed harsher tax treatment on cross-border than domestic transactions.

Double taxation is different. Analysis of double taxation under the fundamental freedoms is more difficult than cases the Court has considered previously because the disadvantage of double taxation is created by the concurrent application of the

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[24] *See, e.g.*, Case C-294/97, Eurowings Luftverkehrs AG v. Finanzamt Dortmund-Unna, 1999 E.C.R. I-7447. *See generally* MASON, PRIMER, *supra* note 3, at 36–38.

[25] Case C-311/97, Royal Bank of Scotland plc v. Greece, 1997 E.C.R. I-2651.

[26] Case C-264/96, Imperial Chemical Industries plc v. Colmer, 1998 E.C.R. I-4695. Under the British group loss relief regime, one subsidiary's tax losses could be surrendered to another subsidiary in the corporate group and used to offset the second subsidiary's taxable income. *See id.*

laws of two taxing jurisdictions, rather than just one.[27] If the ECJ were to hold that double taxation violates the EC Treaty, it would presumably also have to decide *which* state, source or residence, is responsible to relieve the double taxation. Nor is double taxation a problem that can be cured by harmonization of domestic tax laws. Unlike many tax problems in the European Union, double taxation does not arise simply because Member State tax systems are different from each other.[28] Double taxation would persist even if all Member States had *exactly the same* tax laws because double taxation arises from the simultaneous assertion of source taxing rights by the source country and residence taxing rights by the residence country. Even if every country had the same source and residence rules, they would still overlap, resulting in double taxation.[29]

The question of whether unrelieved double taxation, like any other tax hindrance, constitutes a violation of the fundamental freedoms is nearly as old as the EC Treaty itself.[30] Double taxation imposes a burden on cross-border transactions that wholly domestic transactions do not face. In this sense, double taxation disadvantages taxpayers who exercise their fundamental freedoms under the EC Treaty.[31] Since the risk of unrelieved double taxation of cross-border economic activities in the Community poses a hindrance to competition and hampers the effectiveness of the Internal Market,[32] the ECJ unsurprisingly views the abolition of double taxation as a Community goal.[33] However, until the Court's decision in *Kerckhaert & Morres*, it had given no specific guidance on this issue, even though it arguably had the opportunity to do so in the *Gilly*[34] and *van Hilten*[35] cases.[36]

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[27] *See* Jens Schönfeld, *Doppelbesteuerung und EG-Recht*, 2006 STEUER & WIRTSCHAFT 79, 80 (2006). *See also* Case C-374/04, Test Claimants v. Comm'rs of Inland Revenue, 2006 E.C.R. I-11673, ¶ 48 (Feb. 23, 2006) (opinion of Advocate General Geelhoed).

[28] *See* Case C-385/00, De Groot v. Staatssecretaris van Financiën, 2002 E.C.R. I-11819 (holding that the Netherlands' practice of reducing a resident taxpayer's personal deductions in proportion to the taxpayer's foreign source income, which was exempt from tax in the Netherlands, violated the taxpayer's freedom of movement of workers because the other states in which he worked did not grant him a proportional increase in personal deductions).

[29] Case C-374/04, Test Claimants v. Comm'rs of Inland Revenue, 2006 E.C.R. I-11673, ¶ 48 (Feb. 23, 2006) (opinion of Advocate General Geelhoed).

[30] *See* Albert J. Rädler, *Entspricht unser Außensteuerrecht der Neuordnung unserer Außenwirtschaft im Gemeinsamen Markt*? 1960 STEUER & WIRTSCHAFT 729, 731 (1960).

[31] *See* Wolfgang Schön, *Freie Wahl zwischen Zweigniederlassung und Tochtergesellschaft – ein Grundsatz des Europäischen Unternehmensrechts*, 2000 EUROPÄISCHES WIRTSCHAFTS- & STEUERRECHT 281, 290 (2000); Joachim Englisch, *The European Treaties' Implications for Direct Taxes*, 33 INTERTAX 310, 323–324 (2005) (arguing that double taxation might be viewed as a *de facto* discrimination) [hereinafter Englisch, *European Treaties' Implications*].

[32] Moris Lehner, *A Significant Omission in the Constitution of Europe*, 50 BRIT. TAX REV. 337, 338 (2005).

[33] *See* Case C-336/96, Gilly v. Directeur des Services Fiscaux du Bas-Rhin, 1998 E.C.R. I-2793, ¶ 16; Case C-265/04, Bouanich, 2006 E.C.R. I-923, ¶ 49. *See also* Case C-376/03, D. v. Inspecteur van de Belastingdienst, 2005 E.C.R. I-5821, ¶ 78 (Oct. 26, 2004) (opinion of Advocate General Ruiz-Jarabo Colomer).

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

[35] Case C-513/03, Heirs of M.E.A. van Hilten-van der Heijden, 2006 E.C.R. I-1957.

[36] In these two decisions, the ECJ presupposed both existing double tax relief provisions and actual relief when it held that Member States are "competent to determine the criteria for taxation on income and wealth with a view to eliminating double taxation." Case C-336/96, Gilly v. Directeur des Services Fiscaux du Bas-Rhin, 1998 E.C.R. I-2793, ¶ 26. However, the Court gave no guidance about what should

In its jurisprudence in areas other than direct taxation, the ECJ has provided some guidance on how disadvantages arising from the application of two states' laws will be treated. The Court recognizes that even in the absence of overt nationality discrimination, facially neutral statutes may violate the fundamental freedoms by placing a "dual burden" on cross-border activities.[37] Disadvantages created by the uncoordinated application of two or more national legal systems could hamper EU nationals' access to markets in other Member States.[38] The ECJ has considered such dual burdens in at least three situations: (1) regulation, (2) value-added taxation, and (3) social security.

The concept of "double burdens" in the area of overlapping regulation was first illustrated in the landmark *Cassis de Dijon*[39] case. The Court ruled that German regulations requiring a minimum alcohol content of 25% for fruit liquors was contrary to Article 28 EC because it led to the exclusion from sale of spirits manufactured in other Member States that allowed the sale of liquors with lower alcohol content. French regulations permitted the sale of Cassis de Dijon with an alcohol content between 15 and 20%, but because German regulations required a higher alcohol content, Cassis de Dijon was excluded from the German market. Thus, the German regulations prevented the importation of foreign goods that had been designed with their home state's regulations in mind.

The Court's judgment in *Cassis de Dijon* led to the liberal "mutual recognition" principle for the free movement of goods in the Community. Under this principle, goods that "have been lawfully produced and marketed in one of the Member States"[40] are *prima facie* free to circulate in all other Member States irrespective of the importing state's own requirements. Under mutual recognition, measures that hinder the interstate movement of goods are presumptively incompatible with Article 28 EC, *even if they are non-discriminatory*, unless the hindering Member State demonstrates that its public interest is not adequately protected by the origin state's law. Since *Cassis de Dijon*, double regulatory burden cases have also arisen under Articles 39,[41] 43,[42] and 49 EC.[43] The cases show that, like goods, services are

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happen when double taxation is not eliminated. For analysis, including the case law concerning economic double taxation, see KOFLER, DOPPELBESTEUERUNGSABKOMMEN, *supra* note 16, at 180–192.

[37] *See, e.g.*, Englisch, *European Treaties' Implications*, *supra* note 30, at 324 ("twofold or even multifold 'regulation'"). *See also* Case C-190/98, Volker Graf, 2000 E.C.R. I-493, ¶ 26 (Sept. 16, 1999) (opinion of Advocate General Fennelly).

[38] For detailed analysis of the prohibition of non-discriminatory restrictions, see Axel Cordewener, *The Prohibitions of Discrimination and Restriction Within the Framework of the Fully Integrated Internal Market, in* EU FREEDOMS AND TAXATION 1, 7 (Frans Vanistendael ed., 2006).

[39] Case 120/78, Rewe-Zentral AG ("Cassis de Dijon"), 1979 E.C.R. 649.

[40] *Id.* ¶ 14.

[41] *See, e.g.*, Case 16/78, Choquet, 1978 E.C.R. 2293 (concerning German criminal proceedings for driving without a license against a French national who lived and worked in Germany, since under German rules, a foreigner living in Germany for more than one year was obliged to obtain a German driving license); Case C-234/97, Fernández, 1999 E.C.R. I-4773 (concerning Spanish legislation requiring validation of academic qualifications obtained in another Member State for the pursuit of a non-regulated profession).

[42] *See, e.g.*, Case C-340/89, Vlassopoulou , 1991 E.C.R. I-2357 (concerning a Greek lawyer and member of the Athens bar who was educated in law at a German university and worked with a German law firm for five years who was denied admission as a lawyer in Germany because she did not fulfill the conditions required under German law); Case C-55/94, Gebhard, 1995 E.C.R. I-4165 (concerning

particularly vulnerable to obstacles arising from double burdens. Service providers are unlikely to satisfy the host state's regulations if they have only an insignificant presence in the host state, and full compliance with the host state's rules would entail the risk of subjecting a market participant to duplicative regulatory regimes.[44] As a result, the host state is, in principle, prohibited from subjecting the service provider to its regulatory regime. Instead, the host Member State must take into account requirements already fulfilled by the service provider in the Member State of origin.[45] With some exceptions, this also holds true for the freedom of movement of workers and the freedom of establishment.

It is tempting to transpose the principle of mutual recognition applied by the ECJ in regulatory areas to the situation of double taxation. Overlaps in the rules of two jurisdictions cause both dual regulation problems and double taxation And just as duplicative Member State regulation may hinder the intra-Community movement of goods, services, and workers, so may duplicative taxation. The ECJ even applied reasoning similar to the mutual recognition principle in a tax administration case. *Futura Participations* involved a Luxembourg rule that required foreign branches to keep their accounting books physically in Luxembourg and according to Luxembourg accounting rules in order to receive certain tax benefits.[46] As a result of this rule, a company established in another Member State that had a branch in Luxembourg would have to keep two sets of books, one in Luxembourg that complied with Luxembourg's accounting rules, and one in its home state that complied with the home state's accounting rules. The ECJ held that the Luxembourg rules constituted a restriction on the freedom of establishment, and that as a host State, Luxembourg must allow a branch to keep its books according to its home country's law. Although the Court applied mutual-recognition-like reasoning

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criminal proceedings against a German lawyer (Rechtsanwalt), working in Italy without fulfilling the prerequisites under Italian law).

[43] *See, e.g.*, Case 279/80, Webb, 1981 E.C.R. 3305 (concerning Dutch legislation that made the provision of manpower within the Netherlands subject to possession of a license in the case of an undertaking established in another Member State, in particular when that undertaking held a license issued by the other state); Case C-288/89, Collectieve Antennevoorziening Gouda, 1991 E.C.R. I-4007 (concerning conditions imposed on the transmission by operators of cable networks of radio or television programs broadcast from the territory of other Member States); Case C-76/90, Säger, 1991 E.C.R. I-4221 (concerning a requirement for a foreign "patent monitor" to qualify as a member of a particular profession, such as German patent agent, to provide services for undertakings established in Germany); Case C-43/93, Vander Elst, 1994 E.C.R I-3803 (concerning French legislation that required undertakings from other Member States entering France, in order to provide services that lawfully and habitually employed nationals of non-Member States, to obtain work permits for those workers from a national immigration authority and to pay the attendant costs); Case C-3/95, Reisebüro Broede, 1996 E.C.R. I-6511 (concerning German legislation prohibiting an undertaking established in another Member State from securing judicial recovery of debts owed to others); Case C-222/95, Parodi, 1997 E.C.R. I-3899 (concerning national legislation requiring authorization in order to supply banking services where the bank was established in and authorized by another Member State).

[44] *See, e.g.*, Case C-272/94, Guiot, 1996 E.C.R. I-1905, ¶ 10; Case C-3/95, Reisebüro Broede, 1996 E.C.R. I-6511, ¶ 25; Case C-222/95, Parodi, 1887 E.C.R. I-3899, ¶ 18; Joined Cases C-369/96 & C-376/96, Arblade, 1999 E.C.R. I-8453, ¶ 33; Case C-58/98, Corsten, 2000 E.C.R. I-7919, ¶ 33. *See also* Case C-76/90, Säger, 1991 E.C.R. I-4221, ¶ 12; Case C-43/93, Vander Elst, 1994 E.C.R. I-3803, ¶ 14.

[45] Case C-288/89, Collectieve Antennevoorziening Gouda 1991 E.C.R. I-4007, ¶12; Cases C-34/95, C-35/95 and C-36/95, De Agostini 1997 E.C.R. I-3843, ¶ 51; Case 279/80, Webb, 1981 E.C.R. 3305, ¶ 20.

[46] Case C-250/95, Futura Participations and Singer, 1997 E.C.R. I-2471.

to administrative requirements related to taxation, the Court has never applied the mutual recognition principle to a substantive tax case. One reason for this may be the Court's reluctance to confer upon only one State the exclusive right to tax a cross-border item of income.[47]

The second area in which the Court considered whether "dual burdens" violate EC law is indirect taxation.[48] In the early stages of value added tax (VAT) harmonization, for example, cross-border private-to-private dealings suffered double indirect taxation whenever the exporter could not obtain a credit against or refund of input VAT (as a taxable business normally could) and the importer had to pay VAT upon the import. The *Schul I* case,[49] however, made it clear that the Member State of destination must grant a (limited) credit for the input VAT levied in the state of exportation to avoid such double taxation.

The Court's ruling that double indirect taxes violate Community law initially seems closely related to the question of whether double direct taxes violate Community law. However, the ECJ expressly limited the approach taken in *Schul I* to areas harmonized by secondary Community law, in which the contours of the tax (e.g., taxable event, tax liability, and tax base) are uniform throughout the Community.[50] This is an important limitation when considering whether the dual burden analysis could be extended to juridical double taxation, since unlike VAT, direct taxes are largely unharmonized in the European Union.[51] But notwithstanding its express limitation in *Schul I*, the ECJ arguably extended the dual burden approach beyond areas harmonized by secondary Community law in a subsequent indirect tax case. In *Lindfors*,[52] the ECJ held that a Member State could not assess an automobile registration tax on new residents if that tax would place new residents in a less favorable position than permanent residents, taking into consideration similar taxes the new resident may have paid in other Member States.[53] The ECJ came to this conclusion even though it held that the car tax was not, in principle, harmonized by or precluded under secondary Community law.[54]

Finally, the most instructive examples for direct taxation of double burdens relate to challenges of social security legislation under Articles 39, 43, and 49 EC.[55]

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[47] *See* discussion *infra* Part II.D.

[48] Case 15/81, Schul I, 1982 E.C.R. 1409; Case 299/86, Drexl, 1988 E.C.R. 1213, ¶ 9; Case 47/84, Schul II, 1985 E.C.R. 1491, ¶ 12; Case 39/85, Bergeres-Becque, 1986 E.C.R. 259, ¶ 10.

[49] Case 15/81, *Schul I*.

[50] Case 165/88, Oro Amsterdam Beheer, 1989 E.C.R. 4081, ¶ 18; Case C-72/92, Scharbatke, 1993 E.C.R. I-5509; Case 142/77, Statens Kontrol, 1978 E.C.R. 1543, ¶ 33. *See also* AXEL CORDEWENER, EUROPÄISCHE GRUNDFREIHEITEN UND NATIONALES STEUERRECHT 867, 881 (2002) [hereinafter CORDEWENER, EUROPÄISCHE GRUNDFREIHEITEN]; Dennis Weber, *In Search of a (New) Equilibrium Between Tax Sovereignty and the Freedom of Movement Within the EC*, 34 INTERTAX 582, 589 (2006); KOFLER, DOPPELBESTEUERUNGSABKOMMEN, *supra* note 16, at 193–205.

[51] There are some limited areas in which direct taxation has been legislatively harmonized. *See* references *infra* note 86.

[52] Case C-365/02, Lindfors, 2004 E.C.R. I-7183 (concerning car registration taxation).

[53] *Id.* ¶ 35. *Lindfors* can be seen as a double burden case because the Commission argued on behalf of the taxpayer that a similar tax had already been assessed by the State of origin. *Id.* ¶ 23.

[54] *Id.* ¶ 26.

[55] Joined Cases 62/81 & 63/81, Seco, 1982 E.C.R. 223 (Article 49 EC); Case C-53/95, Kemmler, 1996 E.C.R. I-703 (Article 43 EC); Case C-272/94, Guiot, 1996 E.C.R. I-1905 (Article 49 EC); Joined

These cases generally concerned situations where the host Member State assessed social security taxes without taking into consideration the fact that a person had already fulfilled his or her social security obligation to his or her Member State of origin. The Court has consistently ruled that Community law precludes host state legislation that requires participation of a Union citizen in its social security scheme if the person already participates in the social security scheme of his or her Member State of origin and the host state's social security system does not provide additional social protection.

This well-established line of cases suggests that dual burdens are unacceptable, even in areas, such as social security insurance, before they have been harmonized under secondary Community law.[56] Although social security taxes are more directly linked to the (potential) benefits for the payer than are general income taxes, the social security cases are nonetheless legally and factually similar to questions of juridical double income taxation: both involve simultaneous application by two Member States of laws leading to cumulative tax burdens for cross-border economic actors. The ECJ's holdings that cumulative social security and car tax burdens contravene the fundamental freedoms suggest that double taxation in the largely unharmonized area of direct taxation could likewise contravene the fundamental freedoms.

Early legal scholarship regarded juridical double taxation as outside the scope of the fundamental freedoms.[57] But scholars have reconsidered the conclusion that the EC Treaty does not reach double taxation in light of the "double burdens" jurisprudence just described. These cases suggest that the disadvantages for cross-border activities created by double taxation fall within the broad scope of the fundamental freedoms. Article 14 EC gives weight to that conclusion because it states that the "internal market shall comprise an area without internal frontiers in

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Cases C-369/96 & C-376/96, Arblade, 1999 E.C.R. I-8453 (Article 49 EC); Case C-302/98, Sehrer, 2000 E.C.R. I-4585 (Article 39 EC). *See also* Case C-43/93, Vander Elst, 1994 E.C.R. I-3803 (Article 49 EC).

[56] *See, e.g.*, Joined Cases 62/81 & 63/81, Seco, 1982 E.C.R. 223; Case C-53/95, Kemmler, 1996 E.C.R. I-703; Case C-272/94, Guiot, 1996 E.C.R. I-1905; Joined Cases C-369/96 & C-376/96, Arblade, 1999 E.C.R. I-8453; Case C-302/98, Sehrer, 2000 E.C.R. I-4585; Case C-43/93, Vander Elst, 1994 E.C.R. I-3803. For analysis of this line of cases in the light of secondary Community law and for further discussion of the principle of mutual recognition, see KOFLER, DOPPELBESTEUERUNGSABKOMMEN, *supra* note 16, at 206–220.

[57] *See, e.g.*, A. J. Rädler, *supra* note 30, at 731; EDUARD WESSEL, DOPPELBESTEUERUNG UND EWG-VERTRAG 146–159 (1988); ULRICH EYLES, DAS NIEDERLASSUNGSRECHT DER KAPITALGESELLSCHAFTEN IN DER EUROPÄISCHEN GEMEINSCHAFT 377–378; (1990); Paul Farmer, *Article 48 EC and the Taxation of Frontier Workers*, 20 EUR. LAW REV. 310, 315 (1995); Manfred Mössner and Dietrich Kellersmann, *Grenzenlose Steuern – Fiktion oder Wirklichkeit?*, 1995 DEUTSCHES VERWALTUNGSBLATT 968, 970 (1995); HARALD SCHAUMBURG, INTERNATIONALES STEUERRECHT ¶ 14.5 (Schmidt, 2d ed. 1998); Paul Farmer, *EC Law and National Rules on Direct Taxation: A Phoney War?*, 7 EC TAX REV. 13, 14 (1998); Hartmut Hahn, *Grenzüberschreitende Berücksichtigung von Betriebsstättenverlusten? – Bemerkungen zu einer neu entfachten Diskussion*, 11 INTERNATIONALES STEUERRECHT 681, 686 (2002); Peter J. Wattel, *Corporate Tax Jurisdiction in the EU with Respect to Branches and Subsidiaries; Dislocation Distinguished from Discrimination and Disparity: A Plea for Territoriality*, 12 EC TAX REV. 194, 199 (2003); Gammie, *supra* note 21, at 276. *See also* Ekkehart Reimer, *Die Auswirkungen der Grundfreiheiten auf das Ertragsteuerrecht der Bundesrepublik Deutschland*, *in* GRUNDFREIHEITEN IM STEUERRECHT DER EU-STAATEN 39, 58 -59 (Moris Lehner ed., 2000).

which the free movement of goods, persons, services and capital is ensured."[58] Against the background of Article 14 EC and the developing case law of non-discriminatory restrictions created by double burdens, a shift in prevailing legal opinion has taken place. Recently scholars have argued that the fundamental freedoms prohibit double direct tax burdens.[59] The European Commission also took this position, when it argued that "Member States are bound by the EC Treaty principle of free movement within the Community to avoid and eliminate double taxation, at least by imputing a tax paid in the other Member State on their own charge to tax."[60] With a growing consensus that juridical double tax contravenes the fundamental freedoms, academic discussion turned to the question of whether the source State or the residence State should have the primary obligation to relieve double taxation, and whether the particular method of double tax relief is also prescribed by Community law.[61]

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[58] EC Treaty, *supra* note 2, art. 14.

[59] *See, e.g.*, Wolfgang Schön, *Europäische Kapitalverkehrsfreiheit und Nationales Steuerrecht*, in GEDÄCHTNISSCHRIFT FÜR B. KNOBBE-KEUK 743, 761–773 (Wolfgang Schön ed., 1997); NORBERT DAUTZENBERG, UNTERNEHMENSBESTEUERUNG IM EG-BINNENMARKT 687–692 (1997); Carsten R. Beul, *Beschränkung europäischer Niederlassungsfreiheit und Art. 220 EGV – Doppelbesteuerung und Meistbegünstigung –*, 6 INTERNATIONALES STEUERRECHT (1997), 1, 2–4; Schön, *supra* note 30, at 290; CORDEWENER, EUROPÄISCHE GRUNDFREIHEITEN, *supra* note 50, at 876–887; VAN THIEL, FREE MOVEMENT, *supra* note 21, at 41, 313–315; Servaas van Thiel, *Removal of Income Tax Barriers to Market Integration in the European Union: Litigation by the Community Citizen Instead of Harmonization by the Community Legislature?* 12 EC TAX REV. 4, 10 (2003); Servaas van Thiel & Charlotte Achilles, *Die Beseitigung ertragsteuerlicher Hindernisse im Binnenmarkt: Eine Darstellung der Einflüsse der Rechtsprechung des EuGH auf die Ertragsbesteuerung in der Europäischen Union*, 12 INTERNATIONALES STEUERRECHT 530, 534 (2003); Fred C. de Hosson, *The Slow and Lonesome Death of the Arbitration Convention*, 31 INTERTAX 482, 483 (2003); Joachim Englisch, *Zur Dogmatik der Grundfreiheiten des EGV und ihren ertragsteuerlichen Implikationen*, 2003 STEUER UND WIRTSCHAFT 88, 93 (2003); Volker Heydt, *Einfluss des Gemeinschaftsrechts auf die Doppelbesteuerung*, *in* AUSLEGUNG UND ANWENDUNG VON DOPPELBESTEUERUNGSABKOMMEN 32, 48, 53 (Wilhelm Haarmann ed., 2004); Arne Schnitger, *Die Kapitalverkehrsfreiheit im Verhältnis zu Drittstaaten - Vorabentscheidungsersuchen in den Rs. van Hilten, Fidium Finanz AG und Lasertec*, 14 INTERNATIONALES STEUERRECHT 493, 500 (2005); Jens Schönfeld, *Hinzurechnungsbesteuerung zwischen Steuerwettbewerb und Europäischen Grundfreiheiten*, 2005 STEUER UND WIRTSCHAFT 158–170 (2005); Ralph Obser, *§ 8a KStG im Inbound-Sachverhalt – eine EG-rechtliche Beurteilung*, 14 INTERNATIONALES STEUERRECHT 799, 800–801 (2005); JOACHIM ENGLISCH, DIVIDENDENBESTEUERUNG 252–262 (2005); Englisch, *European Treaties' Implications*, *supra* note 30, at 323; Schönfeld, *supra* note 27, at 80; Stefan Enchelmaier, *Meistbegünstigung im EG-Recht – Allgemeine Grundsätze*, *in* MEISTBEGÜNSTIGUNG IM STEUERRECHT DER EU-STAATEN 93, 100 (Axel Cordewener et al. eds., 2006); Joachim Englisch, *Meistbegünstigung im EG-Steuerrecht: Der Weg ins Chaos*, *in* MEISTBEGÜNSTIGUNG IM STEUERRECHT DER EU-STAATEN 163, 175–184 (Axel Cordewener et al. eds., 2006); Georg Kofler, *Treaty Override, juristische Doppelbesteuerung und Gemeinschaftsrecht*, 16 STEUER UND WIRTSCHAFT INTERNATIONAL 62–69 (2006) [hereinafter Kofler, *Treaty Override*]; Helmut Loukota, *Gebietet EU-Recht einen DBA-Anrechnungsvortrag?*, 16 STEUER UND WIRTSCHAFT INTERNATIONAL 250–253 (2006); Frans Vanistendael, *The ECJ at the Crossroads: Balancing Tax Sovereignty Against the Imperatives of the Single Market*, 46 EUR. TAX'N 413, 418–419 (2006); ARNE SCHNITGER, DIE GRENZEN DER EINWIRKUNGEN DER GRUNDFREIHEITEN DES EG-VERTRAGES AUF DAS ERTRAGSTEUERRECHT 258 (2006); KOFLER, DOPPELBESTEUERUNGSABKOMMEN, *supra* note 16, at 177–264.

[60] Answer given by Mr Bolkestein on behalf of the Commission to Written Question E-2287/99 by Karin Riis-Jørgensen (ELDR) to the Commission concerning "Right to freedom of movement and Danish tax rules," 2000 O.J. (C 225) 87.

[61] *See infra* Part II.C. *See also* KOFLER, DOPPELBESTEUERUNGSABKOMMEN, *supra* note 16, at 177–264, 619–694.

So much for academic conclusions. Advocate General Geelhoed took an entirely different position in his opinions in *ACT Group Litigation*[62] and *Kerckhaert & Morres*,[63] arguing that double taxation is a mere "quasi-restriction" that does not violate the fundamental freedoms. Advocate General Geelhoed defined quasi-restrictions as disadvantages stemming from the co-existence of multiple and independent Member State tax systems. Like the obligation to file tax returns in more than one State, Advocate General Geelhoed argued juridical double taxation is the inevitable result of the interaction of multiple tax systems when each country asserts income tax jurisdiction on the basis of residence and source.[64] These disadvantages would continue to exist even if national tax systems were perfectly harmonized. Advocate General Geelhoed further concluded that such disadvantages may not be challenged under the fundamental freedoms, because: (1) Member States have the independent sovereign power to allocate tax jurisdiction among themselves and to choose criteria for taxation, and (2) no criteria for the distribution of taxing rights can be derived from Community law.[65] The ECJ seems to have ratified this reasoning in *Kerckhaert & Morres* by implying that the fundamental freedoms do not provide taxpayers protection from juridical double taxation *per se*.[66]

B. Kerckhaert & Morres

Kerckhaert & Morres[67] was one of several cases on dividend taxation recently decided by the ECJ.[68] It was, however, special in that it involved juridical double

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[62] Case C-374/04, Test Claimants v. Comm'rs of Inland Revenue, 2006 E.C.R. I-11673 (Feb. 23, 2006) (opinion of Advocate General Geelhoed). Advocates General are members of the Court of Justice, but they do not decide cases. It is "the duty of the Advocate General, acting with complete impartiality and independence, to make, in open court, reasoned submissions on cases which, in accordance with the Statute of the Court of Justice, require his involvement." EC Treaty, *supra* note 2, art. 222(2). The opinion of the Advocate General is generally available well before the decision of the Court of Justice, and although not legally binding, the ECJ follows it in about 80 percent of cases. *See, e.g.*, Paul Meller, *Monti Hits Snag in Merger Spat. Attempt Fails to Alter Tetra-Sidel Ruling*, INT'L HERALD TRIB., May 26, 2004, at Finance 2, 2004 WLNR 5205532. The Advocate General is impartial and does not represent any party to the case, including the Member States.

[63] Case C-513/04, Kerckhaert & Morres, 2006 E.C.R. I-10967 (Apr. 6, 2006) (opinion of Advocate General Geelhoed).

[64] *Id.* ¶ 31. *See also* Case C-374/04, Test Claimants v. Comm'rs of Inland Revenue, 2006 E.C.R. I-11673, ¶ 48 (Feb. 23, 2006) (opinion of Advocate General Geelhoed); Case C-524/04, Thin Cap Group Litigation (June 29, 2006) (opinion of Advocate General Geelhoed), 2007 E.C.R. ___, *available at* http://curia.europa.eu/en/content/juris/index.htm.

[65] *See* Case C-513/04, Kerckhaert & Morres, 2006 E.C.R. I-10967, ¶ 31 (Apr. 6, 2006) (opinion of Advocate General Geelhoed); Case C-374/04, Test Claimants v. Comm'rs of Inland Revenue, 2006 E.C.R. I-11673, ¶ 51 (Feb. 23, 2006) (opinion of Advocate General Geelhoed). Some scholars support this approach, see Douma, *supra* note 8, at 532; Weber, *supra* note 48, at 591. The *Nygård* case has been invoked as a possible precedent for this position (erroneously, in our view). *See* Case C-234/99, Nygård, 2002 E.C.R. I-3657. *Nygård* is distinguishable because it concerned not only two different taxes but also two separate taxable events (export of live animals on the one hand and slaughter abroad on the other hand). *See* Enchelmaier, *supra* note 59, at 93, 100, n. 48.

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

[67] *Id*.

[68] *See* Case C-315/02, Lenz v. Finanzlandesdirektion für Tirol, 2004 E.C.R. I-7063; Case C-319/02, Manninen, 2004 E.C.R. I-7477; Case C-446/04, FII Group Litigation, 2006 E.C.R. I-11753 (all concerning inbound dividends). *See also* Case C-374/04, Test Claimants v. Comm'rs of Inland Revenue, 2006 E.C.R. I-11673; Case C-170/05, Denkavit Internationaal BV, 2006 E.C.R. I-11949 (both concerning outbound dividends). *Cf.* Case E-1/04, Fokus Bank ASA v. Norway, [2005] 1 C.M.L.R. 10 (Eur. Free

taxation and posed the question of whether the shareholder's residence state must avoid juridical double taxation by crediting withholding taxes levied by the source state. A married couple, Mr. Kerckhaert and Ms. Morres, both Belgian taxpayers, received dividends in 1995 and 1996 from a company resident in France. In accordance with the French-Belgian double tax treaty, France assessed a 15% withholding tax on the dividends before they were remitted to Kerckhaert and Morres in Belgium.[69] When Kerckhaert and Morres declared the dividends on their personal income tax return in Belgium, Belgium assessed a tax of 25%, but it did not credit the French withholding tax.[70] Belgium's failure to credit the French withholding tax seemed to run counter a provision in the French-Belgian tax treaty, which stated that Belgium would credit the French withholding, but Belgian courts previously had ruled that Belgium did not violate the tax treaty by refusing to credit French withholding.[71] Instead, the French tax was merely deducted from the tax

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Trade Area Ct. Nov. 23, 2004), *available at* http://www.eftacourt.lu/default.asp?layout=article&id=270 (EFTA Court decision concerning outbound dividends in an imputation system).

[69] Case C-513/04, Kerckhaert & Morres, 2006 E.C.R. I-10967, ¶ 7 (citing Article 15(3) of the French-Belgian tax treaty). At the time, France operated an imputation system to relieve economic double taxation of corporate profits under which the corporate tax was fully or partially imputed onto the income tax due on dividends at the shareholder level. This imputation credit (*avoir fiscal*) was granted to all domestic shareholders, and it was also extended to foreign shareholders through tax treaties. When the imputation credit was extended to foreign shareholders, it was added to the dividend and both were subject to 15% French withholding taxation. Because we focus on juridical double taxation, rather than economic double taxation, for purposes of our discussion, we ignore the *avoir fiscal*. Likewise, the ECJ did not consider the effects of the *avoir fiscal*, but rather focused on the unrelieved juridical double taxation because the request for preliminary ruling from the national court focused on the juridical double tax question. The ECJ did not specifically rule on the appropriateness of considering the French *avoir fiscal*, and no mention of the *avoir fiscal* appears in the case. In contrast, the Advocate General did consider the *avoir fiscal*. *See* Case C-513/04, Kerckhaert & Morres, 2006 E.C.R. I-10967, ¶ 31 (Apr. 6, 2006) (opinion of Advocate General Geelhoed).

Commentators observed that because France granted the *avoir fiscal* to foreign shareholders, Mr. Kerckhaert and Ms. Morres in fact paid less tax on the dividends from France than they would have paid on an equivalent dollar amount of dividends received from a company resident in Belgium. *See* Patrick Smet & Hannes Laloo, *ECJ to Rule on Taxation of Inbound Dividends in Belgium*, 45 EUR. TAX'N 158 (2005). Seizing this line of argument, Advocate General Geelhoed concluded that "the actual effect of the operation of the French system was that Belgian-resident shareholders received a higher amount in the case of French-source dividends than in the case of exactly the same amount of dividends distributed from a Belgian company." Case C-513/04, Kerckhaert & Morres, 2006 E.C.R. I-10967, ¶ 25 (Apr. 6, 2006) (opinion of Advocate General Geelhoed). The Advocate General therefore found that "Belgian residents receiving French-source dividends are not worse off in comparison to those receiving Belgian-source dividends; on the contrary, the combined effect of the French and Belgian tax systems means that overall they are better off." *Id.* ¶ 26. Accordingly, Advocate General Geelhoed found no discrimination or restriction within the meaning of Article 56 EC. *Id.* ¶ 30. This analysis suggests that, contrary to ECJ precedent, tax discrimination by one Member State may compensated by tax benefits conferred by another Member State. *But see* Case C-294/97, Eurowings Luftverkehrs AG v. Finanzamt Dortmund-Unna, 1999 E.C.R. I-7447 (holding that higher taxation of non-resident taxpayers could not be justified by the fact that the non-residents were subject to lower tax rates in their home Member State). *See also* Smet & Laloo, at 159; Jacques Malherbe & Melchior Wathelet, *Pending Cases Filed by Belgian Courts: The Kerckhaert-Morres Case*, *in* ECJ RECENT DEVELOPMENTS IN DIRECT TAXATION 29, 58 (Michael Lang et al. eds., 2006).

[70] Case C-513/04, Kerckhaert & Morres, 2006 E.C.R. I-10967, ¶¶ 5, 7.

[71] The language of the applicable tax treaty (Article 19.A) suggested that Belgium was obligated to grant a credit for the tax withheld by France. The treaty provided that the tax due in Belgium would be reduced "first, the withholding tax imposed at the normal rate, and, second, a fixed percentage of foreign tax that is deductible under conditions fixed by Belgian law, provided that such percentage may not be lower than 15% of that net amount." *Id.* ¶ 8. However, Belgian courts found Article 19.A of the Belgian-

base in Belgium.[72] Although both domestic and cross-border dividends were subject to a 25% tax rate in Belgium, and thus appeared to be treated equally, the combination of French withholding and Belgian failure to credit the French withholding resulted in a higher tax burden for cross-border dividends,[73] as follows:

		Domestic (Belgian) Dividend	**Foreign (French) Dividend**
a.	Gross Dividend	1,000	1,000
b.	Foreign (French) Withholding Tax (15%)[74]	—	(150)
c.	Income Tax Basis in Belgium[75]	1,000	850
d.	Belgian Income Tax (25%)	(250)	(212.50)
e.	Credit of Foreign (French) Withholding Tax	—	—
f.	Tax Burden in Belgium	(250)	(212.50)
g.	Total Tax Burden[76]	(250)	(362.50)
h.	Net Dividend[77]	750	637.50

In light of the difference in taxation between domestic and cross-border dividends described in the table above, the Belgian national court asked the ECJ whether Article 56 EC must be:

> interpreted as prohibiting a restriction resulting from a provision in the income tax legislation of a Member State . . . which subjects dividends from resident companies and dividends from companies resident in another Member State to the same uniform tax rate, without in the latter case providing for the imputation of tax levied at source in that other Member State.[78]

In this way, the Belgian court asked the ECJ whether juridical double taxation is inconsistent with the fundamental freedoms.

French tax treaty to be "redundant." Because the tax treaty provision merely memorialized benefits available under Belgian domestic law, Belgian courts held that the tax treaty provided no rights beyond those contained in Belgian domestic law. Thus, when domestic law was reformed to eliminate the credit, the credit could no longer be claimed under the tax treaty. *See* Marc Quaghebeur, *ECJ to Examine Belgian Treatment of Inbound Dividends*, 37 TAX NOTES INT'L 739, 741 (2005); Smet & Laloo, *supra* note 69, at 158.

[72] Smet & Laloo, *supra* note 69.

[73] *Id. See also* Quaghebeur, *supra* note 70.

[74] In reality, the French withholding tax was assessed against the principal amount of the dividend plus the *avoir fiscal*. Because we ignore the *avoir fiscal* for purposes of our example, we calculate the French withholding only on the principal amount of the dividend. The Court of Justice also did not consider the *avoir fiscal*. *See* discussion *supra* note 69.

[75] Line a plus line b.

[76] Line b plus line f.

[77] Line a plus line g.

[78] Case C-513/04, Kerckhaert & Morres, 2006 E.C.R. I-10967, ¶ 14. Most tax cases arise before the ECJ as preliminary ruling requests from national courts. *See* MASON, PRIMER *supra* note 3, at 17–21. Under Article 243 EC, national courts may (and in some cases must) refer to the ECJ questions relevant to cases pending before them that require the interpretation of EC law. The ECJ's decisions on preliminary ruling requests bind national courts to that interpretation. *See* EC Treaty, *supra* note 2, art. 234.

Referral to the ECJ of a cross-border dividend case involving juridical double taxation came as no surprise, since in 2003, the Commission had addressed this problem in its Communication on *Dividend Taxation of Individuals in the Internal Market.*[79] The Commission argued that higher taxation of cross-border dividends should be viewed as a restriction on the free movement of capital prohibited by Article 56 EC. But if a restriction arises from the combination of the French withholding tax and the Belgian shareholder-level tax, which Member State is to blame? In its 2003 Communication, the Commission concluded that where a tax treaty grants the source country the right to levy a withholding tax and foresees a credit in the residence country, the residence State has the obligation under Community law to avoid double taxation by granting a credit.[80] The Commission's position could be understood as concluding that: first, relief of juridical double taxation is required under the fundamental freedoms, and second, where the source and residence State have concluded a tax treaty, priority for which state must relieve double taxation under Community law should be determined by reference to that tax treaty.

Hence, although the Belgian courts had found that Belgium's refusal to credit French withholding on inbound dividends did not violate the French-Belgian tax treaty,[81] under the Commission's position, Belgium would nevertheless be responsible under EC law to credit French withholding, because Belgium entered into a tax treaty with France that allowed France to withhold on dividends paid from French companies to Belgian shareholders in contemplation of a credit by Belgium. Thus, the Commission would rely on existing tax treaties to allocate responsibility for relieving juridical double taxation that violates the fundamental freedoms. Advocate General Geelhoed and the ECJ, however, took a different approach in *Kerckhaert & Morres.*

Advocate General Geelhoed argued that, although the overall tax burden in Belgium was higher for cross-border than domestic dividends, "[s]uch a potential disadvantage for Belgian residents receiving French dividends would not . . . result from any breach of the [EC] Treaty," and "the free movement provisions of the [EC] Treaty do not as such oblige home states to relieve juridical double taxation resulting from the dislocation of [the] tax base between two Member States."[82] He went on to state that:

> the possibility of juridical double taxation, in the absence of priority rules between the relevant States, is an inevitable consequence of the generally accepted method under international tax law of dividing tax jurisdiction

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

[80] *Id.* at 18.

[81] Article 19.A(1) of the French-Belgian tax treaty provided that Belgium would credit the French withholding tax. *See Kerckhaert & Morres*, ¶ 8. However, Belgium did not credit the French withholding because it amended its domestic law to eliminate the credit. *Id.* ¶ 12. In Belgium's view, the failure to credit French withholding did not violate the tax treaty because the credit in the treaty was conditional on its availability under Belgian domestic law. Therefore, abolition of the tax benefit under Belgian domestic law terminated the tax treaty entitlement to that benefit. *See* discussion *supra* note 71.

[82] Case C-513/04, Kerckhaert & Morres, 2006 E.C.R. I-10967, ¶ 29 (Apr. 6, 2006) (opinion of Advocate General Geelhoed).

> between States . . . . Under Community law, the power to choose criteria of, and allocate, tax jurisdiction lies purely with Member States . . . .[83]
>
> [T]he mere fact that a home State such as Belgium might not have chosen to relieve juridical double taxation on dividends would not in itself be contrary to Articles 43 or 56 EC, as long as that State complied with the obligation not to discriminate between foreign-source and domestic-source dividends in exercising its tax jurisdiction . . . . Any distortion of economic activity resulting from such a choice would result from the fact that different tax systems must, in the present state of development of Community law, exist side by side, which may mean disadvantages for economic actors in some cases, and advantages in other cases.[84]

In Advocate General Geelhoed's view, juridical double taxation was thus a "quasi-restriction," and as such it "may only be eliminated through the intervention of the Community legislator."[85]

The Court's judgment was less elaborate, but it followed the reasoning of Advocate General Geelhoed. The ECJ acknowledged that the tax disadvantage to Kerckhaert and Morres resulted from the parallel exercise of fiscal sovereignty by two Member States, and it noted the importance of tax treaties to eliminate or mitigate the negative effects of the coexistence of national tax systems on the functioning of the Internal Market. But the Court concluded that—except for the Parent-Subsidiary-Directive, the Arbitration Convention, and the Savings-Directive[86]—no uniform or harmonized measure designed to eliminate juridical double taxation had yet been adopted at the Community level and, as a result:

> Community law . . . does not lay down any general criteria for the attribution of areas of competence between the Member States in relation to the elimination of double taxation within the Community . . . .
>
> Consequently, it is for the Member States to take the measures necessary to prevent situations such as that at issue in the main proceedings by applying, in particular, the apportionment criteria followed in international tax practice.[87]

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[83] *Id.* Geelhoed based his conclusions on the Court's reasoning in Case C-336/96, Gilly v. Directeur des Services Fiscaux du Bas-Rhin, 1998 E.C.R. I-2793.

[84] Case C-513/04, Kerckhaert & Morres, 2006 E.C.R. I-10967, ¶ 36 (Apr. 6, 2006) (opinion of Advocate General Geelhoed).

[85] *Id.* ¶ 38.

[86] Council Directive 90/435 of 23 July 1990 on the Common System of Taxation Applicable in the Case of Parent Companies and Subsidiaries of Different Member States, 1990 O.J. (L 225) 6, as amended by Council Directive 2003/123, 2004 O.J. (L 7) 41; Convention on the Elimination of Double Taxation in Connection with the Adjustment of Profits of Associated Enterprises, 90/436/EEC, July 23, 1990, 1990 O.J. (L225) 10 (EC), as amended; and Council Directive 2003/48 of 3 June 2003 on Taxation of Savings Income in the Form of Interest Payments, 2003 O.J. (L 157) 38. That the Court makes reference to the Savings Directive as a measure designed to eliminate double taxation is striking, insofar as the sole aim of this Directive is to ensure effective taxation of savings income. It is not clear why the Court referred to this Directive and did not also refer to the Interest & Royalty Directive, which, according to its preamble, explicitly aims to ensure that "double taxation is eliminated" and "that interest and royalty payments are subject to tax once in a Member State." Council Directive 2003/49 of 3 June 2003 on a Common System of Taxation Applicable to Interest and Royalty Payments Made between Associated Companies of Different Member States, 2003 O.J. (L 157) 49.

[87] Case C-513/04, Kerckhaert & Morres, 2006 E.C.R. I-10967, ¶¶ 22–23.

As a result, the Court concluded that although the Belgian tax treatment of the dividend resulted in unrelieved double taxation, it did not infringe the fundamental freedoms.

Although *Kerckhaert & Morres* could on its facts easily be distinguished from other potential cases of juridical double taxation,[88] the decision of the Court implies that juridical double taxation *per se* is not contrary to the fundamental freedoms. Therefore, elimination of double taxation would require positive legislative action at the Community level. However, strong opposition has been voiced in the European Commission,[89] the Court,[90] and legal scholarship,[91] so *Kerckhaert & Morres* may not be the final word on the issue of double taxation.

C. Criticism of Kerckhaert & Morres

The ECJ's decision in *Kerckhaert & Morres* is disappointing from an Internal Market perspective, and it is subject to criticism on multiple levels.[92] First, the Court did not even attempt to distinguish direct taxation from those areas of law where it has found double burdens to infringe the fundamental freedoms.[93] The ECJ may have been concerned that if it had decided that double taxation infringed the fundamental freedoms, it would have been called upon to make political decisions as to which Member State must refrain from taxation. The Court may have wanted to avoid such a serious incursion into the political sovereignty of Member States.[94] However, the impact of a ruling by the ECJ that juridical double taxation violates the fundamental freedoms could be limited by the Member States themselves, since the States are free—and even called upon by Article 293 EC—to enter into agreements for the avoidance of double taxation. Revision of tax treaties to comply with the ECJ's ruling could restore to the Member States the power to decide *which state* must relieve double taxation. Tax treaties have always been respected by the ECJ, which considers the Member States competent to determine—including by means of international agreements—the criteria for taxation of income and wealth "with a view to eliminating double taxation."[95] Judicial self-restraint seems inappropriate

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[88] The case could be distinguished on the basis of the French *avoir fiscal* or the deduction allowed by Belgium for French withholding taxes, both of which mitigated the double taxation that Kerckhaert and Morres suffered on their cross-border dividends.

[89] The Commission will bring the Belgian legislation at issue in *Kerckhaert & Morres* before the ECJ again, although it announced its intention to "take into account the ruling by the European Court of Justice in Kerckhaert-Morres, case C-513/04." *See* Commission Press Release, *Direct Taxation: The Commission Decides to Refer Belgium to the Court Over Discriminatory Taxation of Inbound Dividend*s, IP/07/67 (Jan. 22, 2007).

[90] Pending Case C-464/05, Geurts and Vogten, ¶ 60, n. 37 (Feb. 15, 2007) (opinion of Advocate General Kokott) *available at* http://curia.europa.eu/en/content/juris/index.htm.

[91] Anno Rainer, *ECJ Decides on Withholding Taxes on Cross-Border Income*, 35 INTERTAX 63, 64 (2007); KOFLER, DOPPELBESTEUERUNGSABKOMMEN, *supra* note 16, at 231–264.

[92] For extensive analysis and criticism of this case, see KOFLER, DOPPELBESTEUERUNGSABKOMMEN, *supra* note 16, at 167–236.

[93] *See supra* Part II.A. for further references.

[94] *See* Weber, *supra* note 48, at 590. *Cf.* Mason, *U.S. Tax Treaty Policy*, *supra* note 18, at 95–103.

[95] Case C-336/96, Gilly v. Directeur des Services Fiscaux du Bas-Rhin, 1998 E.C.R. I-2793, ¶ 24.

where "the fact that a taxable event might be taxed twice is the most serious obstacle there can be to people and their capital crossing internal borders."[96]

If protection against juridical double taxation were enshrined as part of the fundamental freedoms, that protection could be limited. For example, the taxpayer need not be granted the right to the tax treatment that would obtain in the more favorable jurisdiction. Instead, the taxpayer could only be entitled to treatment equivalent to that available in the *less* advantageous jurisdiction.[97] Greater benefits could be extended by Member States at their option, leaving them free to pursue capital import or export neutrality.

The ECJ denied direct applicability of the fundamental freedoms to juridical double taxation on the grounds that Community law lacked criteria to divide taxing jurisdiction between the Member States. But this line of analysis ignored that in other direct tax cases the Court did not hesitate to divide tax jurisdiction among the Member States, despite the absence of such Community guidelines. For example, the Court imposed its own priority rules in areas of personal tax benefits,[98] cross-border loss utilization,[99] double utilization of depreciation,[100] indirect taxation,[101] and social security.[102] Although we offer no opinion here on the advisability of such tax priority-setting by the Court of Justice, it is relatively commonplace. A related criticism is that the Court failed to analyze whether it could derive a priority rule for the elimination of juridical double taxation from a source other than Community law, such as tax treaties or generally accepted international tax norms.[103]

In addition to ignoring its own double burden jurisprudence and the many areas in which it has engaged in judicial tax priority-setting, the Court of Justice also seems to have ignored its prior jurisprudence on double use of losses. In prior cases, the ECJ's decisions were motivated by a desire to prevent EU taxpayers from using

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[96] Case C-376/03, D. v. Inspecteur van de Belastingdienst, 2005 E.C.R. I-5821 (Oct. 26, 2004), ¶ 85 (opinion of Advocate General Ruiz-Jarabo Colomer). The Swiss experience demonstrates that double taxation can be resolved judicially, as the Swiss courts have had to give meaning to the constitutional prohibition of double cantonal taxation. Also, the Commerce Clause of the U.S. Constitution limits the ability of U.S. states to impose double taxation, at least where double taxation results from internally inconsistent state legislation; see *infra* Part III. For more on the internal consistency test under U.S. law, see Walter Hellerstein, *Is "Internal Consistency" Foolish?: Reflections on an Emerging Commerce Clause Restraint on State Taxation*, 87 MICH. L. REV. 138 (1988) [hereinafter *Internal Consistency I*].

[97] *See* Englisch, *European Treaties' Implications*, *supra* note 30, at 325.

[98] *See, e.g.*, Case C-279/93, Finanzamt Köln-Altstadt v. Schumacker, 1995 E.C.R. I-225; Case C-80/94, Wielockx v. Inspecteur der Directe Belastingen, 1995 E.C.R. I-2493.

[99] Case C-446/03, Marks & Spencer plc v. Halsey, 2006 E.C.R. I-10837, ¶ 47. *See also* Vanistendael, *supra* note 59, at 416.

[100] *See, e.g.*, Case C-470/04, N. v. Inspecteur van de Belastingdienst Oost, 2006 E.C.R. I-7409, ¶ *54.*

[101] *Schul I* imposed an obligation on the state of destination to credit the input VAT of the private exporter against the VAT liability of a private importer, which was contrary to the destination principle then enshrined under an early form of VAT harmonization. *See* Case 15/81, Schul I, 1982 E.C.R. 1409. *See also* KOFLER, DOPPELBESTEUERUNGSABKOMMEN, *supra* note 16, at 193–205.

[102] *See, e.g.*, Case C-302/98, Sehrer, 2000 E.C.R. I-4585.

[103] *See, e.g.*, Case C-336/96, Gilly v. Directeur des Services Fiscaux du Bas-Rhin, 1998 E.C.R. I-2793, ¶ 31; Case C-265/04, Bouanich, 2006 E.C.R. I-923, ¶ 16 (July 14, 2005) (opinion of Advocate General Kokott); Case C-376/03, D. v. Inspecteur van de Belastingdienst, 2005 E.C.R. I-5821, ¶ 59, n. 41 (Oct. 26, 2004) (opinion of Advocate General Ruiz-Jarabo Colomer).

tax losses to offset income in more than one Member State.[104] Considered against this jurisprudence, the Court's ruling in *Kerckhaert & Morres* creates a striking asymmetry. Why should the Court protect Member States from taxpayers' double use of losses, but not protect taxpayers from Member States' double taxation of their profits?[105] In an Internal Market, arguably neither is acceptable.

Finally, the Court's ruling rewards the inactivity of Member States, which—contrary to their obligation in Article 293 EC—have not achieved or attempted to achieve comprehensive abolition of double taxation in the Community by means of bilateral or multilateral tax treaties.

D. Which State is to Blame for Double Taxation?

If the ECJ were to conclude that double taxation violates the EC Treaty, it would then face a new dilemma: how to determine which state is obliged to relieve double tax. One possibility is that Member States would be jointly and severally liable to avoid double taxation. In that case, each Member State would have an independent and complete obligation to grant relief, such that the taxpayer could file suit in the source state or the residence state, and recover from either. Member States would be free to settle resulting revenue issues among themselves.

The other option would be to try to determine which state is more responsible for the unrelieved double tax, and to make only that state liable to relieve the disadvantage. First, we have already discussed the Commission's solution, which would be to use tax treaties to determine which State is responsible to relieve double taxation.[106] A second option would be for the EC legislator to create a European framework for the division of taxing rights, under which it would provide priority rules for relief of double tax. Third, in the absence a bilateral tax treaty or harmonized EC law, the ECJ could try to determine which state is to "blame" by reference to international practice. Much insight into international practice could be gleaned from the model double tax convention produced by the Organisation for Economic Co-operation and Development (OECD).[107] Although the OECD Model Tax Convention is not binding on OECD or EU Member States, it has become a European standard,[108] and it is already frequently relied upon by the ECJ.[109]

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[104] *See, e.g.*, Case C-446/03, Marks & Spencer plc v. Halsey, 2006 E.C.R. I-10837, ¶ 47 (holding that limitation on loss relief for non-resident subsidiaries was justified by three factors, one of which was the need to prevent foreign losses from being used twice, since, according to the Court, Member States must be able to "prevent the danger that losses would be used twice").

[105] *See* Vanistendael, *supra* note 59, at 416.

[106] *See supra* notes 79–81 and accompanying text.

[107] *See OECD Model Tax Convention and Commentary*, *reprinted in* 1 MATERIALS ON INTERNATIONAL & EC TAX LAW 45 (Kees van Raad ed., 2006). *See also* CORDEWENER, EUROPÄISCHE GRUNDFREIHEITEN, *supra* note 50, at 887; Vanistendael, *supra* note 59, at 419. Nineteen of the 30 OECD member countries are EU Member States. Of the 27 EU Member States, the following eight are not also members of the OECD: Bulgaria, Cyprus, Estonia, Latvia, Lithuania, Malta, Romania, and Slovenia.

[108] Moris Lehner, *The Influence of EU Law on Tax Treaties from a German Perspective*, 54 BULL. INT'L FISC. DOC. 461, 465 (2000); Vanistendael, *supra* note 59, at 419.

[109] *See, e.g.*, Case C-336/96, Gilly v. Directeur des Services Fiscaux du Bas-Rhin, 1998 E.C.R. I-2793, ¶ 31; Case C-265/04, Bouanich, 2006 E.C.R. I-923, ¶ 16 (July 14, 2005) (opinion of Advocate General Kokott); Case C-376/03, D. v. Inspecteur van de Belastingdienst, 2005 E.C.R. I-5821, ¶ 59, n. 41 (Oct. 26, 2004) (opinion of Advocate General Ruiz-Jarabo Colomer).

The option of imposing the obligation to relieve double taxation on only one Member State is most compelling where the two states have a bilateral tax treaty, but one Member State disregards its obligations under the treaty (e.g., a treaty override). In this situation, the tax treaty itself could provide the guidelines needed to allocate responsibility.[110] If the defendant Member State obliged itself in a legally binding tax treaty to waive its taxing rights in favor of the taxing rights of the other Member State, EC law should defer to that allocation.[111]

One might extend this approach beyond cases of clear treaty override. For example, assume that the view of the Belgian courts is correct: by refusing to credit French withholding on dividends, Belgium did not violate the French-Belgian tax treaty.[112] Nevertheless, it still could be argued that Belgium consented to the French withholding tax in their bilateral tax treaty.[113] Under this view, Belgium's grant of permission to France to levy withholding on outbound dividends (in the French-Belgian tax treaty) and the putative prohibition of double taxation within the Community under the fundamental freedoms combine to place the primary responsibility on Belgium to relieve double tax on dividends inbound from France. Under this theory, Belgium would be liable to relieve the double tax in *Kerckhaert & Morres.*

This approach has limits. What would happen if the interpretation of the tax treaty is disputed? For example, suppose a treaty partner, by way of treaty interpretation, either extends its taxing rights or narrows its obligations, and the other treaty partner does not share its view. Since the ECJ is not competent to interpret tax treaties,[114] it would be for the referring national court and the parties in the proceedings to demonstrate the responsibilities of the Member States under the relevant tax treaty.

We offer no opinion here on whether imposition of exclusive liability to relieve double taxation on a single state would be superior to joint and several liability among the taxing Member States. However, it should be noted that if the Court imposed exclusive liability to relieve double taxation upon one state, serious procedural issues would arise. For example, if the taxpayer filed her claim in the wrong Member State, her claim against the liable Member State might expire before she learned of her error. The Commission could mitigate this risk by initiating infringement proceedings against the other Member State, so that the cases could be joined before the ECJ.

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[110] CORDEWENER, EUROPÄISCHE GRUNDFREIHEITEN, *supra* note 50, at 882; Englisch, *European Treaties' Implications*, *supra* note 30, at 324; Kofler, *Treaty Override*, *supra* note 59, at 69 (2006); Schön, *supra* note 58, at 772.

[111] This position is also implied by *Merida*, in which the ECJ relied on the allocation of taxing powers under a tax treaty to determine responsibility. *See* Case C-400/02, Merida, 2004 E.C.R. I-8471.

[112] *See supra* notes 71 to 81.

[113] Kofler, *supra* note 59, at 69. *See also 2003 Communication on Dividend Taxation*, *supra* note 79, at 18.

[114] *See, e.g.*, Case C-141/99, Algemene Maatschappij voor Investering en Dienstverlening NV (AMID) v. Belgium, 2000 E.C.R. I-11619, ¶ 18; Case C-265/04, Bouanich, 2006 E.C.R. I-923, ¶ 53, n. 47 (July 14, 2005) (opinion of Advocate General Kokott); Case C-513/04, Kerckhaert & Morres, 2006 E.C.R. I-10967, ¶ 37 (Apr. 6, 2006) (opinion of Advocate General Geelhoed).

III. A LITTLE HELP FROM OUR AMERICAN FRIENDS?

So far, we have examined the question of whether the EC Treaty provides a direct remedy to juridical double taxation from the perspective of the ECJ's "double burdens" jurisprudence and its ruling in *Kerckhaert & Morres.* We will now consider how the United States Supreme Court has handled the question of double state taxation. The U.S. approach to double state taxation may shed valuable light on the question of whether eradication of double taxation is necessary for a successful internal market. The free trade provisions of the U.S. Constitution and the EC Treaty have broadly similar aims: to remove legal disincentives to investment across state borders. If an economic actor faces double taxation in the cross-border context, but not in a purely in-state context, the additional tax burden acts as a disincentive for cross-border commerce.

In this Part, we review the most relevant jurisprudence of the Supreme Court on double state taxation and conclude that, like the ECJ, the Supreme Court has not interpreted the Constitution to categorically prohibit double state taxation. However, although the Constitution does not ban double state taxation, the Supreme Court has held some cases of double taxation unconstitutional, namely those that arise from so-called "internally inconsistent" state tax laws. This Part explains the standard for judging whether state tax laws are internally inconsistent and shows that the Belgian scheme for taxing dividends reviewed by the ECJ in *Kerckhaert & Morres* was internally inconsistent. As a result, if a similar tax scheme were adopted by a U.S. state, it would presumably be unconstitutional. Thus, at present, there seems to be greater protection from double taxation in the U.S. common market than the European common market.

A. U.S. Legal Background

The U.S. Constitution does not contain free trade provisions as explicit as the EC fundamental freedoms, but the U.S. Supreme Court has interpreted the Commerce Clause to encompass a "dormant" aspect that prohibits states from discriminating against or unduly burdening interstate commerce. Under the Supreme Court's interpretation, the Commerce Clause grant to Congress of the right to regulate interstate commerce protects free trade within the United States:

> Our system, fostered by the Commerce Clause, is that every farmer and every craftsman shall be encouraged to produce by the certainty that he will have free access to every market in the Nation, that no home embargoes will withhold his exports, and no foreign state will by customs duties or regulations exclude them. Likewise, every consumer may look to the free competition from every producing area in the Nation to protect him from exploitation by any.[115]

Just as the ECJ has interpreted the fundamental freedoms of the EC Treaty to prohibit discriminatory state taxation, the Supreme Court has held that the dormant Commerce Clause prohibits discriminatory taxation by the U.S. states. Although

[115] H.P. Hood & Sons, Inc. v. Du Mond, 336 U.S. 525, 539 (1949).

states may tax interstate commerce, they must not do so in a way that discriminates against or unduly burdens interstate commerce:

> [T]he dormant Commerce Clause [prohibits] certain state taxation even when Congress has failed to legislate on the subject . . . . We have understood this construction to serve the Commerce Clause's purpose of preventing a State from retreating into economic isolation or jeopardizing the welfare of the Nation as a whole, as it would do if it were free to place burdens on the flow of commerce across its borders that commerce wholly within those borders would not bear.[116]

The convergence of purpose behind the dormant Commerce Clause and the EC Treaty's fundamental freedoms may explain the remarkable similarity of reasoning and outcome in cases in which the Supreme Court and the ECJ have considered legally and factually similar issues.[117] Both Courts have consistently held that states may not use their tax systems to favor purely domestic commerce over interstate or intra-Community commerce.

Understanding the Supreme Court's internal consistency test requires a little background on state taxation in the United States, which differs from Member State taxation in the European Union. Like most countries in the world, the EU Member States require income to be reported according to the "separate accounting" method.[118] Under this method, taxable entities report income to each country separately according to the source rules contained in the domestic tax laws of each country.[119] Many countries also require taxpayers resident in their jurisdiction to

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[116] Okla. Tax Comm'n v. Jefferson Lines, Inc., 514 U.S. 175, 179–180 (1995) (citations omitted). *See also* Boston Stock Exch. v. State Tax Comm'n, 429 U.S. 318 (1977) (striking down heavier taxes for interstate stock transfers than in-state stock transfers); Complete Auto Transit, Inc. v. Brady, 430 U.S. 274 (1977) (setting forth substantive criteria for adjudicating the validity of state taxes under the Commerce Clause).

[117] For comparisons of U.S. and EU tax discrimination cases, see Tracy Kaye, *Tax Discrimination: A Comparative Analysis of U.S. and EU Approaches*, 7 FLA. TAX REV. 47 (2005).

[118] Much has been written comparing U.S.-style formulary apportionment and separate accounting. As the EU considers moving to a formulary apportionment system, recent writing has focused on what Europe can learn from the U.S. experience, and how Europe can avoid some of the mistakes that have led to double state taxation in the United States. For evaluation of formulary apportionment proposals for Europe, see JOANN MARTENS-WEINER, COMPANY TAXATION REFORM IN THE EUROPEAN UNION (2006); Charles McLure Jr., *Corporate Tax Harmonization in the European Union: The Commission's Proposals*, 36 TAX NOTES INT'L 775 (2004); Walter Hellerstein & Charles McLure Jr., *The European Commission's Report on Company Income Taxation: What the EU Can Learn from the Experience of the US States*, 11 INT'L TAX & PUB. FIN. 199 (2004). *See generally Communication from the Commission to the Council, the European Parliament and the Economic and Social Committee, Implementing the Community Lisbon Programme: Progress to Date and Next Steps Towards a Common Consolidated Corporate Tax Base (CCCTB)*, COM (2006) 157 final (April. 5, 2006).

[119] For criticism of separate accounting and a proposal that the United States unilaterally move from separate accounting to formulary apportionment for federal taxation of the income of multinational enterprises, see Reuven Avi-Yonah & Kimberly A. Clausing, *Reforming Corporate Taxation in a Global Economy: A Proposal to Adopt Formulary Apportionment* (Hamilton Project Discussion Paper, 2007–08) *available at* http://www.brookings.edu/topics/taxes.aspx.

A taxpayer's income can be manipulated under the separate accounting method using transactions with related parties. For example, to shift income out of a high tax jurisdiction into a low tax jurisdiction, the company in the high tax jurisdiction could purchase products at an artificially inflated price from the company in the low tax jurisdiction. This would reduce the high taxed buying company's income and concomitantly increase the low taxed selling company's income. To prevent such abuse, countries taxing on the basis of separate accounting may require taxpayers to report income and expenses from

report all of their worldwide income. Double taxation arises when both the state where the income is sourced and the state where the taxpayer resides tax the same income.[120] Countries using separate accounting generally avoid double taxation by either exempting their residents' foreign-source income or crediting taxes paid by their residents to source countries.

The separate accounting method can be distinguished from the formulary apportionment method used by the U.S. states to tax business income.[121] Rather than focusing on the (often elusive) geographic source of income, the U.S. states focus on the overall business profits of an integrated enterprise doing business in the United States, and then apportion the taxable income among themselves according to a formula that takes into account the presence of the enterprise's factors of production in each state. Thus, under formulary apportionment, a taxpayer's total apportionable income is calculated without respect to where the income was earned. The income is then apportioned among the states according to a formula that takes into account the presence in each state of factors, such the enterprise's payroll, property, and sales.[122] For example, if a taxpayer had $100 of apportionable income, and 30% of its payroll, property, and sales were located in California, California would apply its tax rate to $30. If every state used the exact same formula to determine the portion of the enterprise's overall income that it could tax, no double taxation would arise, and there would be no need to credit taxes assessed by other states.

The U.S. states use formulary apportionment rather than separate accounting because of the difficulties of determining the precise geographic source of income in highly integrated economies.[123] Use by most states of the U.S. federal income tax rules to determine the income of a multistate enterprise mitigates the risk that double state taxation will arise from differences in how the states calculate income.[124] Additionally, states' use of formulary apportionment rather than source rules to apportion income means that double state taxation generally does not arise from the

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transactions with related parties under the arm's length method. Under this method, rather than reporting the actual price charged in the transaction with the related party, the taxpayer reports the arm's length price, defined as the price that would have been charged if the two parties had been unrelated.

[120] *See supra* Part II.A. Double taxation may also arise in other ways. For example, two countries could each consider themselves to be the source of an item of income.

[121] The U.S. states tax individual income according to the separate accounting method. *See generally* JEROME R. HELLERSTEIN & WALTER HELLERSTEIN, STATE TAXATION ¶¶ 20.05–20.10 (3d ed. 1999 & Supp. 2007).

[122] The most prevalent formula is called the Massachusetts formula, and it equally weighs sales, property and payroll. Under the formula, the average of the ratios of the in-state factor to the overall factor is multiplied by the overall income to arrive at each state's share, so State Z would calculate its portion of a company's income as follows:

$$\frac{\text{Sales in State Z}}{\text{Total Sales}} + \frac{\text{Property in State Z}}{\text{Total Property}} + \frac{\text{Payroll in State Z}}{\text{Total Payroll}} = 3 \times \text{Total Income}$$

The formula is embodied in the Uniform Division of Income for Tax Purposes Act (UDITPA), and used by many U.S. states. For analysis and criticism of UDITPA, see Charles E. McLure Jr., *A Comprehensive and Sensible UDITPA*, 37 STATE TAX NOTES 929 (2005).

[123] *See generally* Avi-Yonah & Clausing, *supra* note 119.

[124] Some risk remains because states are not required to calculate income with respect to the federal tax base and because even when states do use the federal tax base as a starting point, they often make adjustments. HELLERSTEIN & HELLERSTEIN, *supra* note 121, ¶ 7.02.

simultaneous exercise of source tax jurisdiction by one state and residence tax jurisdiction by another state.[125] However, because the U.S. states do not use identical formulas for apportioning income, gaps and overlaps in the formulas lead to gaps and overlaps in state income taxation. The use of different apportionment formulas by the U.S. states has given rise to a number of Commerce Clause challenges by taxpayers claiming that overlaps in state apportionment formulas imposed unjustifiable burdens on interstate commerce.[126]

In 1978, the Supreme Court decided *Moorman Manufacturing*, a case on appeal from the Iowa Supreme Court involving a taxpayer's Commerce Clause challenge of Iowa's single-factor-sales apportionment formula.[127] At the time Moorman brought its case, 44 out of the 45 states imposing income taxes, including Moorman's home state of Illinois, used the same apportionment formula that equally weighed sales, property, and payroll.[128] This formula is known as the "Massachusetts formula."[129] Because Moorman had business activities in both Iowa (its host state) and Illinois (its home state), Moorman was subject to tax in both states. Moorman argued that Iowa's formula for apportioning income according to only one factor was discriminatory in light of the fact that every other state with an income tax, including Illinois, apportioned income according to three factors. Overlaps among states' apportionment formulas could lead to double taxation, which Moorman argued would place an unconstitutional drag on interstate commerce.[130]

Although the Supreme Court agreed that mismatched apportionment formulas could lead to "some overlap" in the tax base, it held that in adopting its apportionment formula, neither Iowa nor Illinois discriminated. The Court noted that the:

> Iowa statute . . . treats both local and foreign concerns with an even hand; the alleged disparity can only be the consequence of the combined effect of the Iowa *and* Illinois statutes, and Iowa is not responsible for the latter.
>
> Thus, appellant's "discrimination" claim is simply a way of describing the potential consequences of the use of different formulas by the two States. These consequences, however, could be avoided by the adoption of any uniform rule; the "discrimination" does not inhere in either State's formula.[131]

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[125] Because U.S. states tax personal income according to source rules, rather than formula apportionment, individual taxpayers may suffer this kind of double state taxation. *See generally* HELLERSTEIN & HELLERSTEIN, *supra* note 121, ¶¶ 20.05–20.10.

[126] *See, e.g.*, Moorman Manufacturing Co. v. Bair, 437 U.S. 267 (1978); Container Corp. of Am. v. Franchise Tax Bd., 463 U.S. 159, 169 (1983).

[127] *Moorman*, 437 U.S. 267 (1978). The portion taxable in Iowa was determined by multiplying Moorman's overall income by a fraction equal to its sales in Iowa over its overall sales. *Id.* at 270.

[128] *Id.* at 270, 276.

[129] *Id.* at 281.

[130] *Id.* at 276. For example, if Moorman had 100% of its sales in Iowa and 100% of its property and payroll in Illinois, and Iowa used single-factor sales while Illinois used the three-factor Massachusetts formula given in note 122 *supra*, Moorman would be subject to tax in Iowa on 100% of its overall income and in Illinois on 66% of its overall income, resulting in a taxable base of 166% of Moorman's overall income.

[131] *Id.* at 278, n. 12.

The Court concluded that it was not clear that "Iowa, rather than Illinois, was necessarily at fault *in a constitutional sense*" for double taxation that resulted from differences in the two states' apportionment formulas.[132] The Court observed that any apportionment formula, including single-factor sales, is necessarily somewhat arbitrary, since apportionment:

> does not purport to identify the precise geographical source of a corporation's profits; rather it is employed as a rough approximation of a corporation's income that is reasonably related to the activities conducted within the taxing State . . . . But the same is true of the Illinois three-factor formula. Both will occasionally over-reflect or under-reflect income attributable to the taxing State.[133]

Since the Constitution prescribes no standards for choosing between two different and arbitrary formulas, the Court refused to do so.[134] As a result, the Supreme Court held that Iowa's deviation from the formula used by Illinois and 43 other states did not constitute discrimination.

The Supreme Court's holding in *Moorman*—that differences in taxation are not necessarily discriminatory and therefore do not necessarily violate the dormant Commerce Clause—resembles similar tax decisions by the ECJ. The ECJ has confirmed that mere differences between domestic tax systems do not necessarily give rise to forbidden restrictions of cross-border activity, and therefore the fundamental freedoms do not provide a basis for extensive judicial harmonization of national tax systems.[135] Every Member State is free to decide on the amount, nature, and method of collection of taxes, without regard to the tax systems of other Member States. In particular, Member States need not heed the tax rates or types of taxes levied by fellow States.[136] Differences in tax rates, calculations of the tax base, and the like, are classified as "disparities," and they do not violate the fundamental freedoms.[137] The Supreme Court in *Moorman* adopted similar reasoning: rather than holding that Iowa discriminated against taxpayers resident in Illinois by adopting an apportionment formula that differed from Illinois', the Supreme Court held that the Iowa formula was merely disparate from the Illinois formula. Differences in taxes among the U.S. states generally do not violate the Commerce Clause, as long as there is no discrimination.

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[132] *Id.* at 277 (emphasis added).

[133] *Id.* at 273.

[134] "The Constitution, however, is neutral with respect to the content of any uniform [apportionment] rule . . . ." *Id.* at 279. *See also* Container Corp. of Am. v. Franchise Tax Bd., 463 U.S. 159, 183–84, n. 20 (1983) (concluding that the three-factor formula is "necessarily imperfect" because, among other reasons, "the weight given to the three factors is essentially arbitrary" and the three factors "do not exhaust the entire set of factors arguably relevant to the production of income," but nevertheless concluding that separate accounting had not been shown to produce less arbitrary results).

[135] *See, e.g.*, Case C-379/92, Peralta, 1994 E.C.R. I-3453, ¶ 48; Case C-384/93, Alpine Investments, 1995 E.C.R. I-1141, ¶ 27; Case C-3/95, Reisebüro Broede, 1996 E.C.R. I-6511, ¶ 42; Case C-124/97, Läärä, 1999 E.C.R. I-6067, ¶ 36; Case C-108/96, MacQuen, 2001 E.C.R. I-837, ¶ 33; Case C-294/00, Gräbner, 2002 E.C.R. I-6515, ¶ 46; Case C-6/01, Anomar, 2003 E.C.R. I-8621, ¶ 80.

[136] *See, e.g.*, German Supreme Tax Court (Bundesfinanzhof), Case X R 2/00, BFHE 203, 263 (discussing the "principle of territoriality"). *See also* CORDEWENER, EUROPÄISCHE GRUNDFREIHEITEN, *supra* note 50, at 846.

[137] *See* Case C-385/00, De Groot v. Staatssecretaris van Financiën, 2002 E.C.R. I-11819, ¶ 85.

When analyzing the ECJ's decision in *Kerckhaert & Morres*, we speculated that one reason the ECJ may have been reluctant to rule that double taxation violates EC law was that it would then be faced with the difficult task of determining which state is responsible to cure the double taxation.[138] Although the ECJ has displayed willingness to establish tax priority rules in limited circumstances in other tax cases, it may have felt that establishing general priority rules for taxing cross-border income exceeded its institutional competence.[139] In *Moorman*, the Supreme Court made its concerns explicit. The Supreme Court concluded that elimination of double taxation would require the states to apply a uniform apportionment formula. However, the Court concluded that Congress, not the courts, should impose the uniform standard, because the correct formula is a fundamentally legislative question:

> While the freedom of the States to formulate independent policy in this area may have to yield to an overriding national interest in uniformity, the content of any uniform rules to which they must subscribe should be determined only after due consideration is given to the interests of all affected States. It is clear that the legislative power granted to Congress by the Commerce Clause of the Constitution would amply justify the enactment of legislation requiring all States to adhere to uniform rules for the division of income. It is to that body, and not this Court, that the Constitution has committed such policy decisions.[140]

The Supreme Court's unwillingness to interpret the Commerce Clause as demanding a uniform apportionment formula that would prevent double state taxation derived from its view that the judicial branch was not constitutionally empowered to impose such a uniform formula. Uniformity should either be imposed by the states themselves, or by the federal legislature.

B. "Internal Consistency" Required for Apportionment Formulas

The Supreme Court's holding in *Moorman* was not its last word on double state taxation. Subsequent cases challenging disparate apportionment formulas gave rise to the Court's articulation of the "internal consistency" test in 1983 in *Container Corporation of America v. Franchise Tax Board*.[141] In *Container*, the taxpayer

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[138] *But see supra* notes 99 to 106 and accompanying text, in which we raised the argument that finding double taxation incompatible with the EC Treaty would not require the ECJ to take the further step of determining which state is responsible to relieve double taxation.

[139] For prior ECJ cases establishing tax priority rules, see *supra* notes 99 to 106 and accompanying text.

[140] Moorman Manufacturing Co. v. Bair, 437 U.S. 267, 280 (1978).

[141] 463 U.S. 159 (1983). For more on internal consistency, see generally Hellerstein, *Internal Consistency I*, *supra* note 96. Despite a recent case narrowing internal consistency, Professor Hellerstein concluded that the doctrine remains important. *See* Walter Hellerstein, *Is "Internal Consistency" Dead?: Reflections on an Evolving Commerce Clause Restraint on State Taxation*, 61 TAX L. REV. ___ (forthcoming 2007). For the case narrowing internal consistency, see Am. Trucking Ass'ns, Inc. v. Mich. Pub. Serv. Comm'n, 125 S. Ct. 2419, 2422–23 (2005) (holding that even though Michigan's $100 annual fee on trucks engaged in commercial hauling within Michigan was internally inconsistent, it did not violate the Commerce Clause because it was non-discriminatory, only imposed on intrastate commerce, and did not attempt to tax activity outside of Michigan). *But see* American Trucking Ass'ns, Inc. v. Scheiner, 483 U.S. 266 (1987) (invalidating Pennsylvania's unapportioned fees and axel taxes imposed on trucks engaged in interstate commerce because internally inconsistent, and therefore discriminatory);

brought Due Process and Commerce Clauses challenges against California's three-factor formula for apportioning income to the state.[142] Writing for the Court, Justice Brennan noted that the Constitution requires a state's apportionment formula to be fair, and the "first, and again obvious, component of fairness . . . is what might be called internal consistency—that is, that the formula must be such that, if applied by every jurisdiction, it would result in no more than all of the unitary business's income being taxed."[143] Thus, under the internal consistency test, the Court asks: If all fifty states adopted the challenged formula, would multiple taxation inevitably result?[144] If so, the apportionment rule is invalid.

In *Container*, there was no dispute over whether California's three-factor formula was internally consistent: if all 50 states used the three-factor formula, then a multistate enterprise's unitary business income would be taxed once, and only once.[145] But notice that the single-factor sales formula challenged in *Moorman* is also internally consistent, notwithstanding that it differs from the three-factor formula approved in *Container*. If every state adopted Iowa's single-factor sales formula, a multistate enterprise's unitary business income would be taxed exactly once. Both formulas pass muster under the internal consistency test, even though companies taxable in both California and Iowa may in fact suffer unrelieved double taxation due to differences between the two formulas.[146] Any actual double tax suffered by taxpayers under internally consistent apportionment formulas must result from disparities between the apportionment formulas of the various states, not from unconstitutional discrimination by Iowa or California. Thus, the internal consistency test targets structural, rather than factual, double taxation.[147]

Okla. Tax Comm'n v. Jefferson Lines, Inc., 514 U.S. 175, 185 (1995) ("a failure of internal consistency shows *as a matter of law* that a State is attempting to take more than its fair share of taxes from the interstate transaction") (emphasis added).

[142] Container Corp. of Am. v. Franchise Tax Bd., 463 U.S. 159 (1983).

[143] *Id.* at 169. The Supreme Court employed the phrase "internal consistency" for the very first time in *Container*. *See* Hellerstein, *Internal Consistency I*, *supra* note 96, at 138.

[144] According to the Court, "[i]nternal consistency is preserved when the imposition of a tax identical to the one in question by every other State would add no burden to interstate commerce that intrastate commerce would not also bear . . . . A failure of internal consistency shows as a matter of law that a State is attempting to take more than its fair share of taxes from the interstate transaction . . . ." Oklahoma Tax Comm'n v. Jefferson Lines, Inc., 514 U.S. 175, 185 (1995) (upholding Oklahoma's sales tax on the full price of tickets sold in Oklahoma for interstate bus travel that began or terminated in Oklahoma).

[145] *Container*, 463 U.S. at 184.

[146] By the same token, a company taxable in both states may have less than 100% of its income apportioned to the two states. Thus, differences in apportionment formulas can lead both to double taxation and non-taxation. *See supra* note 130 for an example of disparate apportionment formulas leading to double taxation.

[147] Oklahoma Tax Comm'n v. Jefferson Lines, Inc., 514 U.S. 175, 185 (1995) ("This test asks nothing about the degree of economic reality reflected by the tax, but simply looks to the structure of the tax at issue to see whether its identical application by every State in the Union would place interstate commerce at a disadvantage as compared with commerce intrastate."). *See also* ARMCO v. Hardesty, 467 U.S. 638, 644 (1984) ("Appellee [State Tax Commissioner] suggests that we should require Armco to prove actual discriminatory impact on it by pointing to a State that imposes a manufacturing tax that results in a total burden higher than that imposed on Armco's competitors in West Virginia. That is not the test.").

Contrast a formula that apportioned income based on both inbound and outbound sales.[148] This formula is structurally internally inconsistent, since if applied by every state, multiple taxation would *inevitably* arise because every cross-border sale would assign the same income to two states. Of course, no state would apply a formula that so obviously violates constitutional standards, but other violations of the internal consistency standard have been successfully challenged, particularly in the area of indirect taxes.[149] The disfavor shown by the ECJ and the Supreme Court for double indirect taxes is a point of similarity in their tax jurisprudence.[150]

The U.S. cases show that, like the ECJ, the Supreme Court has not interpreted the Commerce Clause to require complete elimination of double state taxation.[151] The tax autonomy retained by the U.S. states entitles them to determine their own apportionment formulas, even though selection by the states of different apportionment formulas may result in actual double taxation. However, states' autonomy to select apportionment formulas is not totally unconstrained by the Commerce Clause. A state may not elect an internally inconsistent apportionment formula, defined as one that would inevitably lead to more burdensome taxation of cross-border activities than purely domestic activities if the formula were applied by all the states.

However, in the absence of such structural inconsistency, disparate apportionment formulas do not violate the Constitution, even though differences in apportionment formulas may result in actual double taxation, causing market distortions. Such distortions are the cost of the autonomy of the states to choose their apportionment formulas,[152] and the Supreme Court will only second-guess a state's internally consistent apportionment formula "where the taxpayer has proved

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[148] Iowa's internally consistent single-factor sales formula determined the portion of income taxable in Iowa by multiplying overall income by the ratio of sales *in Iowa* to overall sales. An internally *in*consistent formula would take into account both inbound sales (sales in Iowa) and outbound sales (sales outside Iowa). If this were the only factor, the formula would always apportion 100% of the enterprise's income to every state applying it. If the sales factor were used in combination with other factors, the income apportioned to every state might be less than 100%, but the result would still be structurally internally inconsistent because it would inevitably result in double taxation.

[149] *See, e.g.*, Tyler Pipe Indus., Inc. v. Wash. State Dep't of Revenue, 483 U.S. 232 (1987) (finding that Washington's practice of exempting taxpayers from a manufacturing tax if they were also liable for a wholesaling tax violated internal consistency and preferred in-state business that were more likely to engage in both activities in Washington); American Trucking Ass'ns, Inc. v. Scheiner, 483 U.S. 266 (1987) (finding that Pennsylvania flat taxes assessed against interstate truckers violated internal consistency because if a flat tax were replicated by every state, truckers conducting activity in more than one state would shoulder a greater tax burden than truckers that confined their activity to a single state).

[150] For discussion of the ECJ indirect tax cases, see *supra* notes 48 to 54 and accompanying text.

[151] In rejecting the taxpayer's effort to require California to use separate accounting to determine income taxable by the state, the Court argued that "[i]t would be perverse, simply for the sake of avoiding double taxation, to require California to give up one allocation method that sometimes results in double taxation in favor of another allocation method [separate accounting] that also sometimes results in double taxation." Container Corp. of Am. v. Franchise Tax Bd., 463 U.S. 159, 193 (1983).

[152] *See* American Trucking Ass'ns, Inc. v. Scheiner, 483 U.S. 266, 269 (1987) (recognizing that the "uneven course of decisions in this field reflects the difficulties of reconciling unrestricted access to the national market with each State's authority to collect its fair share of revenues from interstate commercial activity").

by 'clear and cogent evidence' that the income attributed to the State is in fact 'out of all appropriate proportion to the business transacted… in the State.'"[153]

C. Application of Internal Consistency to Kerckhaert & Morres

It is interesting to consider how *Kerckhaert & Morres* would fare under the Supreme Court's internal consistency test.[154] When we hypothetically conform the laws of all the Member States to the Belgian law challenged in that case, it becomes apparent that the Belgian law was not internally consistent. Namely, under the Belgian scheme for taxing dividends, cross-border dividends suffered a tax disadvantage not borne by domestic dividends.

To understand why, we first need to consider how the internal consistency test would apply to a tax system based on separate accounting. Applying the internal consistency test to apportionment formulas adopted by U.S. states is straightforward. The Court simply assumes that every other state adopts precisely the same apportionment formula used by the challenged state and then determines whether nation-wide adoption of that formula would inevitably result in harsher taxation for cross-border than domestic enterprises.[155] But recall that the EU Member States tax according to separate accounting, not formulary apportionment. Rather than resulting from mismatched apportionment formulas, double taxation in Europe may result from the application of source rules by the source country and residence rules by the residence country. Cross-border tax disadvantages arise when both the source and residence country tax the same item of income, and neither offers relief of double tax.

Because of the differences in the U.S. state and EU Member State tax systems, applying the internal consistency test in Europe involves applying the challenged state's laws in both a source and a residence capacity. Applying the *same state's* laws in both capacities will highlight any structural inconsistency in that state's law. Thus, in the case of *Kerckhaert & Morres*, the Court would hypothetically assume that France would apply to the dividend *source* rules identical to Belgium's. Belgium's *residence* rules would also apply to the dividend. The Court would compare the resulting hypothetical taxation of cross-border dividends under Belgian source and Belgian residence rules to Belgium's actual tax treatment of domestic dividends. If the cross-border dividends suffer greater taxation than domestic dividends, Belgium's method for taxing cross-border dividends is internally inconsistent.

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[153] "[W]e have on occasion found the distortive effect of focusing on only one factor so outrageous in a particular case as to require reversal." Moorman Manufacturing Co. v. Bair, 437 U.S. 267, 274 (1978) (quoting Hans Rees' Sons, Inc. v. North Carolina, 283 U.S. 123, 135 (1931)). *Container*, 463 U.S. at 182–3 (citing *Hans Rees' Sons* at 134).

[154] For more on how the U.S. internal consistency test could be applied to EC direct tax cases, see Ruth Mason, A Theory of Tax Discrimination, Jean Monnet Working Paper 09/06, http://www.jeanmonnetprogram.org/papers/06/060901.html.

[155] "Internal consistency is preserved when the imposition of a tax identical to the one in question by every other State would add no burden to interstate commerce that intrastate commerce would not also bear . . . ." Oklahoma Tax Comm'n v. Jefferson Lines, Inc., 514 U.S. 175, 185 (1995).

We know from *Kerckhaert & Morres* that Belgium taxed inbound dividends at 25% after allowing a deduction for the source country's withholding tax. To determine whether Belgium's tax system is structurally internally consistent, we must also take into account how Belgium taxed outbound dividends. Assuming Belgium would levy a typical 15% withholding tax on outbound dividends,[156] the analysis of the Belgian tax system under internal consistency would be identical to the analysis we offered of *Kerckhaert & Morres* in Part II.B., and it reveals the structural flaws inherent in Belgian taxation of cross-border dividends.

	Domestic (Belgian) Dividend	**Cross-Border (French) Dividend**
Gross Dividend	1,000	1,000
Source State Withholding Tax[157]	—	(150)
Income Tax Basis in Residence State	1,000	850
Residence State Income Tax (25%)	(250)	(212.50)
Credit of Source State Withholding Tax	—	—
Tax Burden in Residence State	(250)	(212.50)
Total Tax Burden	(250)	(362.50)
Net Dividend	750	637.50

The first column of the table shows the taxation of Belgian domestic dividends, which are subject to a flat 25% tax rate. The second column shows how a cross-border dividend would be taxed under the assumptions of the internal consistency test. First, we assume that France, applying source rules identical to Belgium's, would assess a 15% withholding tax, leaving a net dividend of $850. Then, when the dividend is repatriated to Belgium, in accordance with Belgian residence rules, Belgium would assess its flat 25% dividend tax rate against the $850 net dividend. Because Belgium only deducts the French withholding tax from the taxable base in Belgium, rather than crediting it against Belgian tax due, cross-border dividends are subject to a higher overall tax rate than domestic dividends.

Thus, although Belgium's application of the same 25% tax rate to domestic and cross-border dividends seems to treat them the same, when we take a broader view of the Belgian dividend tax scheme, we see that the flat 25% tax rate for domestic and cross-border dividends does not account for the fact that cross-border dividends

[156] For purposes of this example, we assume that Member States may assess withholding taxes without infringing the EC Treaty. For analysis of withholding taxes under EC law, see Case C-170/05, Denkavit Internationaal BV, 2006 E.C.R. I-11949 (concerning outbound dividends). Additionally, we again set aside the French *avoir fiscal* granted to Kerckhaert and to Morres because the internal consistency test only examines the law of the defendant state—other states' laws are not relevant. The fact that France granted the *avoir fiscal* on outbound dividends would not be relevant to the determination of whether Belgium's system for taxing cross-border dividends is structurally internally consistent. For the argument that the ECJ should not take compensatory tax benefits in the other state into account when determining whether the defendant state discriminated, see Ruth Mason, *Made in America for European Tax: The Internal Consistency Test*, 44 STAN. J. INT'L L. ___ (forthcoming 2008) *available at* www.ssrn.com [hereinafter, Mason, *Made in America*].

[157] Note that under the hypothetical harmonization of the internal consistency test, France would apply Belgian, not French, source rules. This would mean a 15% withholding tax and no *avoir fiscal.*

have already been taxed by France, the source state. Belgium's failure to credit foreign withholding taxes when it taxes in a residence capacity is inconsistent with its collection of withholding taxes in a source capacity. If adopted by every Member State, the combination of withholding on outbound dividends and failure to credit withholding on inbound dividends would inevitably result in higher taxation of cross-border dividends than domestic dividends. To be structurally internally consistent, a state that assesses withholding taxes on outbound dividends must credit such taxes levied by other states on inbound dividends; taxing foreign and domestic dividends as the same rate does not amount to equal treatment in this case. If the residence state does not credit the source state's withholding tax, it systematically treats cross-border dividends worse than domestic dividends, which arguably violates the EC freedom of capital movement.

To put this assertion in terms of the internal consistency test, if Belgium's system of taxation for domestic and cross-border dividends were adopted by all the Member States, cross-border dividends would *always* bear more tax than domestic dividends. Application of the internal consistency test, with its assumption that all states apply the tax law of the challenged state, allows us to conclude that the disadvantage for cross-border dividends shown in the example above is not the result of a disparity in the tax treatment of the cross-border dividends between Belgium and France. Since in our example France applied law identical to Belgium's (rather than applying French law), the disadvantage must inhere in Belgian law. Thus, the ECJ was wrong to conclude that the tax disadvantage suffered by Kerckhaert and Morres was the result of a nondiscriminatory mismatch between the tax laws of Belgium and those of France. A principal virtue of the internal consistency test is that persistence of disadvantages despite (hypothetical) tax harmonization highlights that the disadvantages do not result from mere disparities.[158]

To make this point clear, and to return to the question of which state is responsible for the discrimination, consider a hypothetical country that imposes 15% withholding on outbound dividends when it taxes in a source capacity. The same country, when it taxes in a residence capacity, grants a credit on inbound dividends for withholding taxes levied by the source state. After crediting foreign withholding, it taxes the dividends at a rate of 25%. Domestic dividends are also taxed at 25%. If this country's tax law were universalized, the difference in treatment between domestic and cross-border dividends disappears:

[158] For more on the advantages of the internal consistency test in the EC tax context, see Mason, *Made in America*, *supra* note 156.

	Domestic Dividend	**Cross-Border Dividend**
Gross Dividend	1,000	1,000
Source State Withholding Tax	—	(150)
Income Tax Basis in Residence State	1,000	1,000[159]
Income Tax (25%)	(250)	(250)
Credit of Source State Withholding Tax	—	150
Tax Burden in Residence State	(250)	(100)
Total Tax Burden	(250)	(250)
Net Dividend	750	750

This example shows that as long as a country pairs withholding on outbound dividends with a credit for withholding on inbound dividends, its tax regime for cross-border dividends will be internally consistent. Interestingly, the approach above was the one contemplated by the Belgian-French double tax treaty before Belgium reformed its domestic law to eliminate the credit for foreign withholding taxes on dividends.[160]

As the Belgian example shows, application of the internal consistency test to double tax cases in the Community would lead to the conclusion in some cases that unrelieved juridical double taxation is in fact the consequence of only one Member State's internally inconsistent tax laws. Where a single State's tax system is internally structurally inconsistent, and that inconsistency leads to a cross-border tax disadvantage, it is easy to assign responsibility to relieve double taxation to that State. *Kerckhaert & Morres* is an example of a case in which the defendant Member State's laws were structurally internally inconsistent.

D. U.S. Prohibition on Restrictions

It is worth mentioning that in addition to prohibiting *discrimination* against interstate commerce, the U.S. Supreme Court, like the ECJ, has interpreted the dormant aspect of the Commerce Clause to prohibit *restrictions* on interstate commerce. The Supreme Court calls these prohibited restrictions "undue burdens." The Supreme Court has struck down non-discriminatory, but unduly burdensome regulations. For example, in *Bibb v. Navajo Freight Lines, Inc.*, the Supreme Court struck down an Illinois safety regulation requiring contoured rear fender mudguards when at least 45 other states permitted or required straight mudguards.[161] Illinois' rule was internally consistent: if every state adopted Illinois' contoured mudguard requirement, there would be no burden on interstate commerce not faced by domestic commerce. The Supreme Court nevertheless struck down the statute because it created an undue burden on interstate commerce that could not be justified

[159] The inbound dividend is "grossed-up," meaning the 25% dividend tax rate in the residence state is assessed against the gross amount of the dividend paid by the company, not against the amount net of the withholding tax assessed by the source state.

[160] *See* discussion of the French-Belgian tax treaty in *supra* notes 69 to 72.

[161] Bibb v. Navajo Freight Lines, Inc., 359 U.S. 523, at 528 (1959).

by the unproven safety advantages Illinois claimed contoured mudguards possessed. Truckers using straight mudguards, who satisfied the safety regulations of Illinois' neighboring states, would expend time and money changing their mudguards to comply with the Illinois regulation.[162] The Supreme Court held that Bibb was "one of those cases—few in number—where local safety measures that are nondiscriminatory place an unconstitutional burden on interstate commerce."[163]

However, like the ECJ with its "double burden" analysis, the Supreme Court has not extended its "undue burden" analysis beyond regulation to double tax cases. The internal consistency test does not help determine whether non-discriminatory rules nevertheless unduly restrict cross-border commercial and capital flows. In *Moorman*, although Justices Powell and Blackmun argued in their dissent that *Bibb* was a relevant, if not controlling, precedent, the majority of the Court was not persuaded that the adoption by Iowa of a non-discriminatory apportionment formula that differed from all the other states' formulas created an undue burden on interstate commerce because it was likely to lead to double state taxation.[164] The dissenting Justices acknowledged that although there could be "no fixed rule" regarding the degree of uniformity required of state laws, the Court must balance the conflicting goals in each case.[165] Justices Powell and Blackmun argued forcefully in *Moorman* that "the difficulty of engaging in that weighing process does not permit this Court to avoid its constitutional duty and allow an individual State to erect an 'unreasonable clog upon the mobility of commerce.'"[166]

Like the ECJ with its dual burden analysis, the U.S. Supreme Court has applied undue burden analysis to cases of duplicative tax administrative burdens. In *National Bellas Hess*[167] and *Quill Corporation*,[168] the Supreme Court ruled that requiring out-of-state sellers with no physical presence in a state to collect sales tax on mail order sales into the state would place an undue burden on interstate commerce.[169] The Court's reasoning was grounded on fears that such a low threshold for the obligation to collect tax would retard interstate commerce because out-of-state sellers would be subjected to "similar obligations . . . imposed by the Nation's 6,000-plus taxing jurisdictions," including "the 'many variations in rates of tax, in allowable exemptions, and in administrative and record-keeping requirements.'"[170]

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[162] Two to four hours were required to install or remove a contoured mudguard. *Id.* at 525.

[163] *Id.* at 529.

[164] "If one State's regulatory or taxing statute is significantly 'out of line' with other States' rules, and if by virtue of that departure from the general practice it burdens or discriminates against interstate commerce, Commerce Clause scrutiny is triggered, and this Court must invalidate it unless it is justified by a legitimate local purpose outweighing the harm to interstate commerce." Moorman Manufacturing Co. v. Bair, 437 U.S. 267, 294 (1978) at 294 (Powell, J., dissenting) (citing *Bibb*, 359 U.S. at 530).

[165] *Moorman*, 437 U.S. at 295–6 (Powell, J., dissenting).

[166] *Id.* at 296 (Powell, J., dissenting) (citation omitted).

[167] National Bellas Hess, Inc. v. Department of Revenue, 386 U.S. 753 (1967) (holding under the Due Process and dormant Commerce Clauses that Illinois had no power to force an out-of-state seller with no physical presence in Illinois to collect sales tax on mail order sales into Illinois).

[168] Quill Corp. v. North Dakota, 504 U.S. 298 (1992).

[169] "Congress is now free to decide whether, when, and to what extent the States may burden interstate mail-order concerns with a duty to collect use taxes." *Id.* at 318.

[170] *Id.* at 313, n. 6 (quoting *Bellas Hess*, 386 U.S. at 759–760).

The U.S. Supreme Court's interpretation of the Commerce Clause as protecting multistate businesses from complying with the diverse tax collection requirements of states and localities with which it has only minimal contacts is similar to the ECJ's interpretation of the freedom of establishment in the *Futura* case. As noted earlier, in *Futura* the ECJ held that Luxembourg could not condition tax benefits on the requirement that a branch physically keep its books in Luxembourg and according to Luxembourg accounting rules.[171] Under the Court's analysis, Luxembourg's record-keeping rules constituted a "restriction" on intra-Community commerce because they imposed a duplicative burden:

> if such a company or firm wishes to carry forward any losses incurred by its branch, it must keep, in addition to its own accounts which must comply with the tax accounting rules applicable in the Member State in which it has its seat, separate accounts for its branch's activities complying with the tax accounting rules applicable in the State in which its branch is established. Furthermore, those separate accounts must be held, not at the company's seat, but at the place of establishment of its branch.[172]

Thus while both the U.S. Supreme Court and the ECJ have held that duplicative indirect taxes and duplicative tax administrative burdens may violate constitutional and treaty prohibitions against burdening interstate and intra-Community commerce, neither has applied these doctrines to bar duplicative income taxation. Despite the precedents set in *Bibb* and *National Bellas Hess* forbidding undue burdens under the Commerce Clause, and despite the urging of dissenting Justices, the majority in *Moorman* did not strike down the single-factor-sales apportionment formula as unduly burdensome.

Because it is an abstract test designed to identify structural defects in statutes arising from the hypothetical replication of the statute in other states, the internal consistency test does not give a court applying it insight into whether an internally *consistent* rule nevertheless imposes actual burdens on cross-border commerce. For example, both the three-factor apportionment formula used by California and the single-factor apportionment formula used by Iowa are internally consistent. However, use by each state of internally consistent but *different* formulas may lead to actual unrelieved double taxation.[173] Thus, if the ECJ or the Supreme Court were interested in completely eliminating double state taxation, some kind of restriction or undue burden analysis that goes beyond the internal consistency test would be necessary.

IV. CONCLUSION

Until 2005, the ECJ's direct tax discrimination cases were amazingly consistent in their outcome: the ECJ almost always invalidated the challenged Member State tax provision as contrary to EC law. The ECJ showed little reluctance to finding Member State tax provisions discriminatory. But recently, Member States have

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[171] Case C-250/95, Futura Participations SA v. Administration des contributions, 1997 E.C.R. I-2471.

[172] *Id.* ¶¶ 24–25.

[173] *See* discussion *supra* Part III.A. and the example in *supra* note 130.

experienced major victories before the Court of Justice in direct tax cases. One wonders whether the tax provisions the Court now upholds are really so different from the provisions it invalidated earlier in its history. Recent decisions on cross-border losses,[174] most-favored nation treatment under double tax treaties,[175] and now on juridical double taxation[176] suggest that the Court is only willing to go so far to achieve judicial tax integration.[177] Are we experiencing a European "switch in time?"[178] Has the Court of Justice succumbed to political pressure from Member States anxious to protect domestic tax revenues, as some commentators have suggested?[179]

Although a holding by the Court of Justice that double taxation violates the fundamental freedoms would have fit comfortably within the Court's prior tax jurisprudence, the Court ruled in *Kerckhaert & Morres* that relief from double taxation is not a requirement under current EC law. This does not necessarily mean that unrelieved double taxation will persist in the Community. The Member States could impose upon themselves a requirement to eliminate double taxation, perhaps by legislation at the EC level. Legislation in the tax area is especially difficult to pass, however, because it requires the unanimous consent of the Council.[180] If sufficient support for elimination of double taxation by means of a legislative Directive does not exist, the Member States have a variety of other options.[181] They could address the problem of double taxation with a multilateral tax treaty,[182] a model bilateral tax treaty for use in tax treaty negotiations between Member

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[174] Case C-446/03, Marks & Spencer plc v. Halsey, 2006 E.C.R. I-10837.

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

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

[177] *See* Michael Lang, *Direct Taxation: Is the ECJ Heading in a New Direction?* 46 EUR. TAX'N 421 (2006).

[178] To prevent the Supreme Court from striking down New Deal legislation, President Roosevelt conceived the so-called court-packing scheme under which he would be entitled to appoint six new Justices to the Supreme Court, which would result in a politically sympathetic majority. In the midst of the controversy, a moderate Justice switched political sides—though he had sided against New Deal legislation in the past, Justice Roberts began voting with the liberal Justices on the Court to uphold New Deal legislation. Additionally, a conservative Justice retired, allowing Roosevelt to appoint one new Justice. Once the Supreme Court started upholding New Deal legislation, President Roosevelt's court-packing scheme quickly lost support. The new readiness of the Supreme Court to back Roosevelt's legislative program has been called the "switch in time that saved nine." For more on the court-packing scheme, see ARTHUR M. SCHLESINGER, JR., *THE AGE OF ROOSEVELT: THE COMING OF THE NEW DEAL* (Houghton Mifflin, 1st ed. 1958).

[179] *See, e.g.*, Servaas van Thiel, *A Slip of the European Court in the* D *Case (C-376/03): Denial of the Most-Favoured-Nation Treatment Because of Absence of Similarity?* 33 INTERTAX 454, 456 (2005).

[180] EC Treaty, *supra* note 2, art. 94 ("The Council shall, acting unanimously on a proposal from the Commission and after consulting the European Parliament and the Economic and Social Committee, issue directives for the approximation of such laws, regulations or administrative provisions of the Member States as directly affect the establishment or functioning of the common market.").

[181] *See Commission Working Paper, EC Law and Tax Treaties,* DOC(05) 2306, ¶ 32.

[182] *See Communication from the Commission to the Council, the European Parliament and the Economic and Social Committee, Towards an Internal Market Without Tax Obstacles—A Strategy for Providing Companies with a Consolidated Corporate Tax Base for Their EU-Wide Activities,* COM (2001) 582 final (Oct. 23, 2001), at 43 [hereinafter *2001 Communication on an Internal Market Without Tax Obstacles*]. For proposals, see MULTILATERAL TAX TREATIES (Michael Lang et al. eds., 1997). For analysis of the 1968 draft of a multilateral tax treaty, see Ulrich Anschütz, *Harmonization of Direct Taxes in the European Economic Community*, 13 HARV. INT'L L. J. 1, 45 (1972).

States,[183] or specific recommendations based on Articles 211 and 249 EC that address the most important issues for the avoidance of double taxation.[184] Although the future is unclear, we support the efforts of the Commission, which consistently stresses that "double taxation is a major obstacle to cross-border activity and investment within the EU" and that "[i]ts elimination is . . . a basic objective and principle of any co-ordinated solution."[185]

A final note could be added from the U.S. perspective on the prospects for a legislative solution to double state taxation. Before the Court's 1978 ruling in *Moorman*, 44 out of the 45 states with income taxes used identical three-factor apportionment formulas. Today, less than 30 years after the *Moorman* Court found that, because the Constitution did not require states to adopt uniform apportionment formulas, uniformity could only be imposed by Congress, not the courts, Congress still has not acted.[186] Only twelve states now require or permit the three-factor formula, with the remainder using a variety of factors and weights to apportion taxable income.[187] Differences among the formulas create both gaps (cases in which income is not taxed by any state) and overlaps (cases in which income is taxed by two or more states). Additionally, the low level of review the U.S. Supreme Court gives apportionment formulas means that states are free to adopt criteria for apportionment that bear little economic relationship to the income earned in each state. After *Moorman*, it seems that no relief from resulting non-discriminatory double taxation—at least in the absence of unconstitutional extraterritorial taxation—will be available from the federal courts under the Commerce Clause, and none has so far been forthcoming from Congress. Still, few would argue that the United States is not a well-functioning common market.

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[183] This could be accomplished as a recommendation. *See 2001 Communication on an Internal Market Without Tax Obstacles*, *supra* note 182, at ¶ 62. It could also be accomplished as a binding framework treaty. For in-depth analysis and a concrete proposal, see PASQUALE PISTONE, THE IMPACT OF COMMUNITY LAW ON TAX TREATIES (2002). *See also* Pasquale Pistone, *An EU Model Tax Convention*, 11 EC TAX REV. 129 (2002).

[184] *See 2001 Communication on an Internal Market Without Tax Obstacles*, *supra* note 182, at ¶¶ 38–54.

[185] *See Communication from the Commission to the Council, the European Parliament and the Economic and Social Committee, Co-ordinating Member States' Direct Tax Systems in the Internal Market*, COM (2006) 823 final, (Dec. 19. 2006) at 5.

[186] Kathryn L. Moore, *State and Local Taxation: When Will Congress Intervene?* 23 J. LEGIS. 171, 173 (1997) (giving reasons why Congress is unlikely ever to impose uniform tax rules on the states).

[187] Federation of Tax Administrators, *State Apportionment of Corporate Income* (Jan. 1, 2006), *available at* http://www.taxadmin.org/fta/rate/corp_app.html.