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A THEORY OF TAX DISCRIMINATION

Ruth Mason*

The fundamental freedoms of the EC Treaty prohibit tax discrimination—harsher tax treatment of cross-border economic activities than purely internal activities. Critics of the ECJ argue that the Court's broad interpretation of the EC freedoms causes it to find tax discrimination where there is none. This tendency encroaches upon the sovereignty of EU member states and hampers their ability to pursue economic policy goals. This Article shows that, contrary to the claims of the Court's critics, the ECJ's errors in tax discrimination cases go in both directions: in addition to finding discrimination where there is none, the Court also sometimes fails to recognize discrimination. The Court's failure to recognize tax discrimination undermines the economic integration of Europe and abridges EU nationals' personal rights.

This Article is the first to identify the Court's standard of review in tax discrimination cases, the comparable internal situation test (CIST), as a source of the Court's error. Instead of CIST, the Article proposes that the ECJ borrow a standard developed by the U.S. Supreme Court for tax cases arising under the Commerce Clause: the internal consistency test (ICT). By adopting this more reliable and predictable standard, the ECJ can better fulfill the policy goals behind the nondiscrimination principle, including promotion of economic efficiency and integration of the European common market.

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INTRODUCTION

The European Union was created to bind the countries of Europe together economically to prevent future wars. Economic integration has been achieved through rigorous enforcement of EU nationals' fundamental economic freedoms before the European Court of Justice (ECJ), including the freedoms of movement of goods, persons, services and capital.[1] These freedoms prohibit tax discrimination—harsher tax treatment of cross-border economic activities than purely internal activities. Critics of the ECJ's tax jurisprudence argue that that the Court finds discrimination too easily—in its desire to forge a unified Europe, it oversteps its institutional role as guardian of the fundamental freedoms of EU nationals and invades the tax sovereignty of the EU member states, thereby constraining their independence to implement tax policy decisions

[1] *See* Single European Act, art. 13, Feb. 17, 1986, 1987 O.J. (L 169) 1. *See* 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].

and influence their economies through tax laws.[2] National politicians and tax administrators forced to replace revenue previously derived from discriminatory taxes are particularly harsh critics.[3] Indeed, the revenue estimates of the ECJ's corporate tax decisions in the United Kingdom alone are £ 10 billion annually, about one-third of annual British corporate tax revenues.[4]

Based on a survey of the ECJ's entire income tax jurisprudence, this Article argues that, in addition to finding discrimination where there is none, the ECJ also sometimes fails to find discrimination where it should. Failure to properly identify tax discrimination undermines the goal of European economic integration and abridges the rights of EU nationals.[5] This Article finds common themes in both kinds of objectionable cases and proposes a new analytical method for ECJ tax cases.

Determining what constitutes income tax discrimination is exceedingly difficult, particularly because cross-border tax disputes usually involve the laws of more than one member state.[6] The method used by the ECJ to determine whether there is discrimination could best be described as the "comparable internal situation test" (CIST). Under this method, the Court compares the complaining taxpayer, often a non-resident with economic connections to the defendant or "host" member state, to a similarly situated taxpayer who resides in the defendant State. If the non-resident receives worse tax treatment than the similarly situated resident, the Court generally concludes that the member state violated the EC Treaty by discriminating against the non-

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[2] *See, e.g.,* Servaas van Thiel, *The Future of the Principle of Non-Discrimination in the EU: Towards a Right to Most Favored Nation Treatment and a Prohibition of Double Burdens? in* COMPARATIVE FISCAL FEDERALISM 331 (Reuven Avi-Yonah, James R. Hines, Jr. & Michael Lang eds., Kluwer 2007); Michael J. Graetz & Alvin C. Warren, Jr., *Income Tax Discrimination and the Political and Economic Integration of Europe*, 115 YALE L. J. 1186 (2006); Dennis Weber, *In Search of a (New) Equilibrium Between Tax Sovereignty and the Freedom of Movement Within the EC*, 34 INTERTAX 585 (2006); Ruth Mason, *U.S. Tax Treaty Policy and the European Court of Justice*, 59 TAX L. REV. 65 (2005); Peter J. Wattel, *Progressive Taxation of Non-Residents and Intra-EC Allocation of Personal Tax Allowances: Why* Schumacker, Asscher, Gilly *and* Gschwind *Do Not Suffice*, 40/6 EUR. TAX'N 210 (2000); John F. Avery Jones, *Carry on Discriminating*, 6 BRIT. TAX REV. 525 (1995).

[3] *See* Philip Baker, *Protection of the Taxpayer by the European Court of Justice*, 44 EUR. TAX'N 453, 453 (2004) ("Tax administrators are finding themselves having to implement tax structure changes which are not economically or administratively efficient and which do not reflect democratic choices. I do not think you can ignore these comments as simply the sour grapes of tax administrations who have lost in litigation before the ECJ.").

[4] Kevin Brown, *Euro Court Tax Ruling Could Lead to Windfall*, FIN. TIMES (London), Sept. 11, 2004, at 1.

[5] The task of the ECJ is to "ensure that in the interpretation and application of [the EC Treaty] the law is observed." EC Treaty, *supra* note 1, art. 220.

[6] The U.S. Supreme Court's struggle with tax discrimination is likewise a "tortuous history" in the view of two leading commentators. JEROME R. HELLERSTEIN & WALTER HELLERSTEIN, STATE TAXATION: CORPORATE INCOME AND FRANCHISE TAXES ¶ 4.08, at 8-185 to 8-187 (2006).

resident.[7] ECJ decisions have been heavily criticized, and some commentators have condemned its whole tax jurisprudence as incoherent, but CIST has never been identified as a particular contributor to the Court's difficulties in the tax area.[8] Given its central role, close scrutiny of this test is long overdue. I will show that it suffers from two major drawbacks.

First, although CIST requires the Court to posit an appropriate internal situation to which the complaining taxpayer's situation can be compared, the ECJ has provided little guidance on how to choose comparable internal situations. Residents and non-residents ordinarily are subject to entirely different tax regimes in the same state. For example, a resident taxpayer is usually taxable on all of his or her worldwide income, whereas a non-resident is generally only taxable on income derived—"sourced" in tax parlance—in the host state.[9] This makes the problem of finding comparable internal situations difficult. Indeed, the ECJ itself has declared that a resident and a non-resident taxpayer are not "generally comparable" for income tax purposes, which naturally raises questions concerning the circumstances under which it is appropriate to compare them.[10] Since the comparison under CIST is outcome-determinative, the choice of which taxpayers to compare is crucial and should be defined carefully.[11]

Second, CIST fails to distinguish between cases of prohibited discrimination and cases of "mere disparity," in which perfectly permissible laws passed by two or more member states happen to interact poorly, thereby creating a tax disadvantage for cross-border taxpayers.[12] Only discriminatory tax laws, not disparate ones, violate the EC Treaty.[13] Greece discriminates when

[7] The ECJ rarely holds that public policy needs justify tax discrimination. *See* RUTH MASON, PRIMER ON DIRECT TAXATION IN THE EUROPEAN UNION 93-115 (2005).

[8] *See* Graetz & Warren, *supra* note 2 (arguing that the ECJ's approach to tax discrimination cases is incoherent); Tracy A. Kaye, *Tax Discrimination: A Comparative Analysis of U.S. and EU Approaches*, 7 FLA. TAX REV. 47, 56 (2005) (arguing that tax discrimination jurisprudence is "confused on both sides of the Atlantic").

[9] *See generally* HUGH J. AULT & BRIAN J. ARNOLD, COMPARATIVE INCOME TAXATION: A STRUCTURAL ANALYSIS 347-350 (2004).

[10] Case C-279/93, Finanzamt Köln-Altstadt v. Schumacker, 1995 E.C.R. I-225, ¶ 31.

[11] For the outcome-determinative nature of the comparison, see Part II.B, *infra*.

[12] "[P]ossible distortions resulting from mere disparities between tax systems do not fall within the scope of the free movement provisions of the Treaty." Case C-374/04, Test Claimants v. Comm'rs of Inland Revenue (Feb. 23, 2006) (opinion of Advocate General Geelhoed), http://curia.europa.eu/en/content/juris/index.htm (search for "Case C-372/04"), ¶ 46.

[13] The ECJ has stated that :

> It is settled case-law that Article 12 EC [prohibiting nationality discrimination] is not concerned with any disparities in treatment, for persons and undertakings subject to the jurisdiction of the Community, which may result from divergences existing between the various Member States, so long as they affect all persons subject to them in accordance with objective criteria and without regard to their nationality.

Case C-403/03, Schempp v. Finanzamt München, 2005 E.C.R. I-0642, ¶ 34.

it taxes national banks at 35%, but foreign banks at 40%.[14] In contrast, if Germany taxed all taxpayers at 40%, while France taxed at only 35%, Germany would commit no nationality discrimination. Although a French national earning income in Germany would be subject to a higher tax rate in Germany than in France, the disadvantage would not stem from her status as a French national or resident. Germany taxes all residents and non-residents at the same rate, that rate just happens to be higher than France's.[15] That is a case of disparity, not discrimination.[16]

Preservation of member state fiscal sovereignty requires the ECJ to distinguishing between disparity and discrimination. By entering into the EC Treaty, the member states agreed not to use their tax systems to discriminate against nationals of other member states, but they retained sovereignty over the substantive aspects of their tax systems, such as the ability to set tax rates and define tax bases.[17] When the ECJ mistakes disparity for discrimination, it invalidates tax laws that are not inconsistent with the EC Treaty, thereby unnecessarily narrowing the member states' methods for raising revenue and exceeding its institutional competence. The member states recognize and resist this encroachment.

Some characterize the Court's tax jurisdiction as judicial activism: the Court's deliberately aggrandizes Community power at the expense of the states.[18] It is unclear to what extent the Court is motivated by politics. However, the fact that application of CIST has also led the Court to mistakenly *approve* discrimination by member states lends support to the notion that, rather than being motivated purely by politics, the Court simply has trouble accurately applying the standard. When the Court mistakenly concludes that cases of nationality discrimination do not offend the EC Treaty because they are mere disparities, the ECJ fails to protect the fundamental rights of EU nationals.

I propose that in lieu of CIST, the ECJ borrow the U.S. Supreme Court's internal consistency test as a new analytical framework for tax discrimination cases. The Supreme Court developed the internal consistency test as part of its own tax discrimination jurisprudence under the dormant

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

[15] Case C-336/96, Gilly v. Directeur des Services Fiscaux du Bas-Rhin, 1996 E.C.R. I-2793.

[16] *See* Wattel, *supra* note 2, at 219 ("the ECJ cannot do anything about disparities, since to remove them, [legislative] harmonization is necessary").

[17] *See, e.g., Gilly* at ¶¶ 24, 30, 34, 46, 48.

[18] *See, e.g.,* Graetz & Warren, *supra* note 2, at 1193, 1232-1236.

Commerce Clause.[19] Rather than positing a comparable internal situation and comparing the complaining taxpayer's treatment by the defendant state to the purely internal situation, the U.S. Supreme Court asks more generally: if all fifty states applied the challenged rule, would cross-border economic actors be systematically disfavored?

Internal consistency is simpler to apply than CIST, and it filters out cases of what I call "false discrimination"—where the ECJ mistakes disparity for discrimination—and cases of "false disparity"—where the ECJ mistakes discrimination for disparity. ICT achieves this conceptual clarity by focusing on the impact of the domestic tax provision on intra-Community commerce, rather than finding comparable internal situations. It also eliminates the tendency of the ECJ to look at the tax situation in the complaining taxpayer's home state. The ECJ's growing tendency to look at the tax situation in member states other than the defendant state is both perilous and inappropriate. It is perilous because it adds complexity and therefore increases the probability of error, and it is inappropriate because the legality of one member state's tax law should not be determined with respect to another's. A member state should not be able to justify tax discrimination by pointing to an offsetting advantage enjoyed by the taxpayer in his or her home state.[20]

Part I discusses the policy reasons for applying a tax non-discrimination norm in a system in which the constituent states of a federal union retain tax sovereignty. Part II compares CIST and ICT and explains how each attempts to identify tax discrimination. Systematic analysis of the ECJ's jurisprudence since its first tax discrimination case in 1986 shows the shortfalls of CIST. Parts III and IV review four recent and highly-contested Court of Justice decisions for errors of false discrimination and false disparity: *De Groot*, *Manninen*, *Schempp*, and *D*.[21] Cases involving personal taxation were chosen since the majority of income tax revenue in the EU derives from personal taxation, and personal tax more directly implicates EU nationals'

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[19] *See* American Trucking Ass'ns, Inc. v. Scheiner, 483 U.S. 266, 284 (1987) ("To pass the 'internal consistency' test, a state tax must be of a kind that, 'if applied by every jurisdiction, there would be no impermissible interference with free trade.'" (quoting Armco Inc. v. Hardesty, 467 U.S. 638, 644 (1984))).

[20] Case C-294/97, Eurowings Luftverkehrs AG v. Finanzamt Dortmund-Unna, 1999 E.C.R. I-7447. *See also infra* Parts II.B.2, III.B.

[21] Case C-385/00, De Groot v. Staatssecretaris van Financiën, 2002 E.C.R. I-11819; Case C-319/02, Manninen, 2004 E.C.R. I-7477; Case C-403/03, Schempp v. Finanzamt München, 2005 E.C.R. I-06421; Case C-376/03, D. v. Inspecteur van de Belastingdienst, 2005 E.C.R. 5821.

individual rights.[22] I show how CIST was applied incorrectly in three out of four of those cases, and how ICT would have made the discrimination question clearer.[23]

ICT is no panacea—although it clarifies the problem of finding comparable taxpayers, it does not solve it. A claim of discrimination is by its nature comparative: the taxpayer claims that he or she is treated worse on account of some characteristic that is not shared with the favored group. ICT does not—as no test could—eliminate the need to make a comparison. However, by simplifying the factual situation, and helping to eliminate cases of false disparity and false discrimination, ICT makes the unavoidable comparison less prone to error.

DISCRIMINATION, DISPARITY, & FISCAL FEDERALISM

Efficiency: Economic Theory of Union

By conferring upon EU nationals personal and judicially enforceable economic rights, the EC Treaty ensured a steady stream of challenges to obstacles to the free movement of goods, services, persons and capital.[24] Why would the member states voluntarily subject their domestic taxes and regulations to judicial review by the European Court of Justice?[25] One view is that the constituent jurisdictions in a fiscal federal system such as the United States or the EU adopt anti-discrimination norms to combat economic inefficiencies stemming from discriminatory taxes.[26] Although a discriminatory tax might benefit a particular state by providing: (1) protection of in-

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[22] In 2002, personal income taxes, excluding social security taxes, represented 25.8% of EU countries' overall tax revenue from all sources, compared with 8.6% for corporate tax. *See* OECD in Figures 2005, available at http://www.oecd.org/document/62/0,2340,en_2825_495698_2345918_1_1_1_1,00.html _follow "Taxation" link. Additionally, other commentators have already focused on the controversial corporate tax cases. *See, e.g.,* Graetz & Warren, *supra* note 2.

[23] Of these four cases, only the judgment in *Manninen* was correct. *See infra* Parts III & IV.

[24] Case C-26/62, Van Gend en Loos v. Nederlandse Administratie der Belastingen, 1963 E.C.R. 1 (holding that EC rights have direct effect;, they give rise to a private right of enforcement in national courts).

[25] *See* EC Treaty, *supra* note 1, arts. 226-228 (providing procedures to bring member states before the Court of Justice for violations of EC law). *See also id.* art. 234 (providing procedure for national courts to request binding interpretations of EC law from the ECJ).

[26] *See, e.g.,* Boston Stock Exch. v. State Tax Comm'n, 429 U.S. 318, 328 (1977) ("the purpose of the Commerce Clause was to create a free trade area"). *See also Communication from the Commission to the Council, the European Parliament and the European Economic and Social Committee*, *Report on the Implementation of the Internal Market Strategy* (2003-2006), COM (2004) 22 final (Jan. 21, 2004) (the purpose of the Internal Market is to increase the "EU's competitiveness, growth, and prosperity").

state operators from out-of-state competition, (2) tax exportation, or (3) incentives for investment by non-residents in the state, such tax measures are thought to reduce the overall efficiency of the federal system by distorting decisions about where to work or invest.[27]

The Courts are concerned about market distortions arising from protectionist state taxes.[28] The Supreme Court invalidated New York's establishment of a minimum price for milk because, like a tariff, it "neutraliz[ed] the advantage possessed by lower cost out-of-state producers."[29] Likewise, when Germany assessed an additional tax on companies that leased assets from out-of-state companies, the Court expressed its concern that Germans "may thus be dissuaded from having recourse to such lessors."[30] In striking down discriminatory taxes, both Courts see themselves as protecting free trade and tax-neutral decision-making.[31]

In addition to protectionism, a state may use discriminatory taxes to shift the cost of providing public goods from its own residents to residents of other states, a strategy called tax exportation. Examples of tax exportation include severance taxes on the exportation of a state's scarce natural resources and assessment of property taxes on an historical cost basis rather than a fair market value basis, which tends to favor long-standing state residents over newcomers.[32] To the extent that a state is able to export taxes by taking advantage of unique natural resources or other monopolies, the threat that other states may enact retaliatory taxes may not be an effective deterrent.[33]

If the choice of where to engage in commerce is elastic—if behavior is responsive to tax considerations—economic activity is more likely to be distorted by discriminatory taxes. The

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[27] Daniel Shaviro, *An Economic and Political Look at Federalism in Taxation*, 90 MICH. L. REV. 895 (1992) (evaluating the U.S. federal system according to the norm of locational neutrality).

[28] *Compare* Metropolitan Life Ins. Co. v. Ward, 470 U.S. 869 (1985) (striking down Alabama's higher tax rate for insurance premiums paid to out-of-state insurers than in-state insurers) *with* Case C-311/97, Royal Bank of Scotland plc v. Greece, 1997 E.C.R. I-2651 (striking down Greece's higher tax rate on foreign banks doing business in Greece than Greek banks).

[29] West Lynn Creamery, Inc. v. Healy, 512 U.S. 186, 192 (1994) (citing Baldwin v. G.A.F. Seelig, Inc., 294 U.S. 511, 527 (1935) and listing other cases considering market distortions).

[30] Case C-294/97, Eurowings Luftverkehrs AG v. Finanzamt Dortmund-Unna, 1999 E.C.R. I-7447, ¶ 37.

[31] *See, e.g.,* Boston Stock Exch. v. State Tax Comm'n, 429 U.S. 318, 328, 331 (1977) (the U.S. "free trade area" was undermined by New York's discriminatory taxes that "foreclosed tax neutral decisions").

[32] *See* Robert P. Inman & Daniel L. Rubinfeld, *Designing Tax Policy in Federalist Economies: An Overview*, 60 J. PUB. ECON. 307 (1996). *Compare* Commonwealth Edison Co. v. Montana, 453 U.S. 609 (1981) (coal severance taxes) *and* Nordlinger v. Hahn, 505 U.S. 1 (1992) (property taxes) *with* Case C-141/99, Algemene Maatschappij voor Investering en Dienstverlening NV (AMID) v. Belgium, 2000 E.C.R. I-11,619 (striking down Belgian rule that required Belgian-source losses to be taken against exempt foreign-source income, rather than be carried over to future years to offset positive Belgian taxable income).

[33] *See* Saul Levmore, *Interstate Exploitation and Judicial Intervention*, 69 VA. L. REV. 563 (1983) (arguing that the Supreme Court is more likely to strike down state taxes or regulations that take advantage of a state monopoly).

economic freedoms available in common markets are designed to increase elasticity of locational decisions.[34] Because those freedoms emphasize cross-border movement, with the express goal of removing state-created barriers to movement, discriminatory taxes in common markets may be particularly distortive.[35]

Overall social welfare may increase if distortions caused by discriminatory state taxes are removed, but the states face a collective action problem. While all would gain if none discriminated, any individual state stands to gain from defection. A federal ban on discriminatory taxation solves the collective action problem, and granting taxpayers private rights of action for tax discrimination ensures enforcement. To the extent that discriminatory taxes are inefficient because they cause taxpayers to arrange their economic affairs differently than they would in the absence of such taxes, prohibition of discriminatory taxes should lead to a more efficient allocation of resources and investments across the federal system.

In contrast with protectionism and tax exportation, the third category of discrimination—creation of incentives for non-residents to invest in the state—is not generally prohibited under the EU fundamental freedoms or the U.S. Commerce Clause [36] Thus, states are relatively free to compete for investment from outsiders by adopting low tax rates or by providing other investment incentives through their tax codes, even though such competition may create a race-to-the-bottom that erodes state tax bases.[37] However, when incentives take the form of subsidies that interfere with the functioning of the common market in the EU, they may be prohibited under the EC Treaty as state aids.[38] In the United States, in contrast, provision of direct subsidies

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[34] *See* Jeremy Edwards & Michael Keen, *Tax Competition and Leviathan*, 40 EUR. ECON. REV. 113 (1996) (noting that international economic integration increases mobility of tax bases and modeling government behavior in light of international tax coordination).

[35] Notwithstanding the legal entitlement to move, barriers to movement may nevertheless persist. Not every EU state has adopted the euro as its currency, and there are language barriers. *See* Sijbren Cnossen, *Tax Policy in the European Union: A Review of Issues and Options*, CESIFO WORKING PAPER NO. 758 (August 2002).

[36] *See* discussion of "reverse discrimination," *infra* text accompanying notes 42 to 44.

[37] Musgrave wrote the following about international tax competition:

> This pattern of tax behavior by the countries of source can lead to tax competition among capital-importing countries with the result that no one country can obtain enough additional investment from abroad to justify the lower tax. Furthermore, such tax competition can have damaging effects on domestic tax equity and possibly on the conduct of the public sector if the tax incentives offered to non-resident investors have to be extended to domestic investors.

Peggy B. Musgrave, *Sovereignty, Entitlement, and Cooperation in International Taxation,* 26 BROOK. J. INT'L L. 1335, 1343 (2001) (calling for international cooperation).

[38] *See* EC Treaty, *supra* note 1, art. 87 ("…aid granted by a Member State… in any form whatsoever which distorts or threatens to distort competition… shall, in so far as it affects trade between Member States, be incompatible with the common market").

and tax expenditures to encourage investment in the state appears to be constitutional, as long as it is not funded by discriminatory taxes.[39]

Equality: Political Theory of Union

A second explanation for the prohibition on tax discrimination is political: discrimination by the states of a federal system against residents of other states undermines political union.[40] This view holds that there is something untoward about discrimination against residents of another state. Such discrimination runs contrary to Justice Cardozo's admonition that the Constitution was founded upon the "theory that the peoples of the several states must sink or swim together, and that in the long run prosperity and salvation are in union and not division."[41]

A related point is the idea that judicial intervention in state taxation may be appropriate if the burden of tax discrimination falls disproportionately on outsiders who do not participate in the political processes in the host state. To the extent that tax non-residence coincides with inability to vote in the state, non-resident taxpayers suffering discrimination may have little democratic recourse.[42] The prohibition on tax discrimination provides these disenfranchised non-residents with extra protection in the host state. The political theory of non-discrimination is supported in both the United States and the European Union by the acceptance of some degree of "reverse discrimination." Reverse discrimination occurs when a state treats its own residents engaged in

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[39] West Lynn Creamery, Inc. v. Healy, 512 U.S. 186, 199 (1994) (striking down a Massachusetts direct subsidy to in-state milk producers that was funded by a tax on in-state and out-of-state milk wholesalers, but declaring that "a pure subsidy funded out of general revenue ordinarily imposes no burden on interstate commerce, but merely assists local business"). *But see* Peter D. Enrich, *Saving the States from Themselves: Commerce Clause Restraints on State Tax Incentives*, 110 HARV. L. REV. 377 (1996) (arguing that distortive state tax incentives violate the Commerce Clause). The Supreme Court granted certiorari last term on a case involving investment tax credits, but due to lack of standing, it did not reach the merits. DaimlerChrysler Corp. v. Cuno, 126 S.Ct. 1854 (2006). *See* Jennifer Carr & Cara Griffith, *Will There Ever Be an Opinion on the Constitutionality of Tax Incentives?* 40 STATE TAX NOTES 619 (2006).

[40] *See, e.g.,* Christopher R. Drahozal, *Preserving the American Common Market: State and Local Governments in the United States Supreme Court*, 7 SUP. CT. ECON. REV. 233, 241 n. 22 (1999) (quoting Laurence H. Tribe as arguing that dormant Commerce Clause derives "principally from a *political* theory of union, not from an economic theory of free trade. The function of the clause is to ensure national solidarity, not economic efficiency"). *But see* Lisa Heinzerling, *The Commercial Constitution*, 1994 SUP. CT. REV. 217 (arguing that Commerce Clause nondiscrimination serves none of its three traditional goals: economic efficiency, representation reinforcement, or national unity).

[41] Baldwin v. G.A.F. Seelig, Inc., 294 U.S. 511, 523 (1935).

[42] *But see* Shaviro, *supra* note 27, at 930 (arguing that cross-border economic actors may have proxy representation in the political system of the host state through state residents, such as customers and other commercial contacts, to whom part of the burden of discriminatory taxation is shifted).

domestic commerce worse than out-of-state residents. Both the Supreme Court[43] and the Court of Justice[44] have sustained such discrimination despite its potential to distort the common market, perhaps because residents facing reverse discrimination can express their dissatisfaction at the polls.

Balancing State Tax Sovereignty

Set against the normative justifications for non-discrimination is the autonomy of each state to pursue its own public policy goals through tax legislation. Although bound by the Constitution and EC Treaty, U.S. states and EU member states retain a great deal of tax sovereignty.[45] Protectionist tariffs are prohibited in both jurisdictions, but state income taxes are harmonized in neither.[46] Differences in income taxation are particularly pronounced in Europe, since unlike the U.S. states, the EU member states do not measure income by reference to a common federal tax base.[47] Persistence of differences between national tax systems—"disparities" in Community parlance—was no accident. While eager to harmonize indirect taxes as part of the creation of the customs union, the original member states wished to retain control

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[43] *See, e.g.,* Allied Stores of Ohio v. Bowers, 358 U.S. 522 (1959) (finding no Equal Protection violation when a state tax favored non-residents over residents); Goldberg v. Sweet, 488 U.S. 252, 266 (1987) (holding that "[i]t is not a purpose of the Commerce Clause to protect state residents from their own state taxes"). *But see id.* at 268-270 (Stevens, J. and O'Connor, J., dissenting) (refusing to join majority's view that the Commerce Clause does not protect residents from their own state); Tyler Pipe Indus., Inc. v. Wash. State Dep't of Revenue, 483 U.S. 232 (1987) (holding tax on resident manufacturers who sold in-state violated the Commerce Clause when equivalent tax was not imposed on resident manufactures who sold out-of-state).

[44] *See, e.g.,* Case C-112/91, Werner v. Finanzamt Aachen-Innenstadt, 1993 E.C.R. I-429 (holding that the freedom of establishment "does not preclude a Member State from imposing on its nationals who carry on professional activities within its territory and who earn all or almost all of their income there… a heavier tax burden if they do not reside in that state than if they do"). *See also* MIGUEL POIARES MADURO, WE, THE COURT 70 (1998).

[45] "'Unless restrained by provisions of the federal Constitution, the power of the state as to the mode, form, and extent of taxation is unlimited, where the subjects to which it applies are within her jurisdiction.'" Shaffer v. Carter, 252 U.S. 37, 50 (1920) (quoting State Tax on Foreign-held Bonds Case, 82 U.S. (15 Wall.) 300, 319 (1872)). "Although, as Community law stands at present, direct taxation does not as such fall within the purview of the Community, the power retained by the Member States must nevertheless be exercised consistently with Community law." Case C-279/93, Finanzamt Köln-Altstadt v. Schumacker, 1995 E.C.R. I-225, ¶ 21.

[46] West Lynn Creamery, Inc. v. Healy, 512 U.S. 186, 192 (1994) ("tariffs against the products of other States are so patently unconstitutional that our cases reveal not a single attempt by any State to enact one."). *See also* EC Treaty, *supra* note 1, art. 23 (forbidding tariffs).

[47] HELLERSTEIN & HELLERSTEIN, *supra* note 6, ¶ 20.02, at 20-1. In contrast, indirect taxes are harmonized in the EU, but not the United States. *See generally*, B. J. M. TERRA & PETER WATTEL, EUROPEAN TAX LAW (2005).

over domestic social and economic policy, and thus they included no obligation to harmonize direct taxes in the Treaty of Rome.[48]

Theoretically, income tax harmonization could be achieved through EU legislation, but it would require unanimity of the Council, which is difficult to attain on direct tax matters.[49] One reason for the difficulty is that EU member states, like most countries, use their tax systems to achieve non-tax goals.[50] The U.S. federal government, for example, provides tax incentives for home ownership, employer-provided health insurance, charitable contributions, and much more.[51] While the economic efficiency and political transparency of such tax expenditures is debatable, they are pervasive.[52] A uniform European tax base would either require agreement among the states about the policies to be pursued through taxation, or a shift away from using tax incentives to achieve social policies. While switching from tax to direct expenditures and regulation for achieving social welfare goals may have salutary effects, disputes would remain concerning how to calculate income and how to set tax rates such that each state could raise enough revenue to enact its social policies through direct expenditures.[53] EU-wide consensus on how progressive taxes should be—or how high tax rates should be—is almost inconceivable. Under the EC Treaty, resolution of these fundamental issues was left to the democratic processes in the various member states. As a result, the EU is a patchwork of differing tax rates and tax bases.

In addition to the political obstacles to legislative approximation of member state tax laws, certain normative considerations favor taxation by smaller constituent governments, rather than central government. These will be familiar to Americans accustomed to the long-standing debate over fiscal federalism.[54] First, state and local governments are thought to be superior providers

[48] Charles E. McLure, Jr., *The Long Shadow of History: Sovereignty, Tax Assignment, Legislation, and Judicial Decisions on Corporate Income Taxes in the U.S. and the EU, in* COMPARATIVE FISCAL FEDERALISM 119, 133 (Reuven Avi-Yonah, James R. Hines, Jr. & Michael Lang eds., Kluwer 2007).

[49] EC Treaty, *supra* note 1, art. 93. *See* MASON, PRIMER, *supra* note 7, at 22-36.

[50] 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 (2003) (the member states "have not allowed the Community to use its legislative instrument to remove tax obstacles to market integration because they did not want to give up their discretion in the income tax area").

[51] *See* I.R.C. §§ 167(h) (home mortgage interest deduction); 106 (employer paid health insurance premium exclusion); 170 (charitable contribution deduction).

[52] Stanley S. Surrey, *Tax Incentives as a Device for Implementing Government Policy: A Comparison with Direct Government Expenditures*, 83 HARV. L. REV. 705 (1970).

[53] Boris Bittker, *Accounting for Federal "Tax Subsidies" in the National Budget*, 22 NAT'L TAX J. 244 (1969) (describing the elusiveness of a normative tax base against which tax expenditures should be measured).

[54] For development and criticism of these arguments in the U.S. context, see Shaviro, *supra* note 27, at 959-974.

of public goods because they are more responsive to voter preferences and better understand local needs than the distant central government. Additionally, decentralized taxation allows for inter-jurisdictional tax competition, which may promote legislative experimentation and prevent both high taxes and dangerous accumulations of political power, thereby offsetting the leviathan tendencies of government. In a federal system that guarantees free movement across the borders of taxing jurisdictions, residents can "vote with their feet" by moving to the jurisdiction which provides the most appealing combination of tax burden and government-provided goods and services.[55] Economic theory predicts that such inter-jurisdictional competition will tend to lower taxes on mobile factors, such as capital.[56] This phenomenon has been observed worldwide, and the European Union is no exception.[57] To offset the risk that competition will lead to a destructive tax "race to the bottom," some nations have embarked on soft law projects that provide checks on "harmful tax competition."[58]

Decentralized taxation carries other risks.[59] For example, locally funded public goods may spill over, benefiting residents of neighboring states who have not contributed to their expense. Spillover is a concern whenever the benefits of regulation cannot be limited to the residents of the particular tax region, as is the case with environmental regulation, redistribution, and military defense.[60] Additionally, certain macroeconomic stabilization functions may better be performed by central government.[61] These risks may be mitigated somewhat in the EU, since cultural and language barriers prevent EU nationals from moving easily across borders, despite their legal entitlement to free movement.[62] Nevertheless, "tax assignment" decisions—those concerning the

[55] *See* Charles M. Tiebout, *A Pure Theory of Local Expenditures*, 64 J. POL. ECON. 416 (1956).

[56] *See, e.g.,* R.A. de Mooij & L.G.M. Stevens, *Exploring the Future of Ability to Pay in Europe*, 2005/1 EC TAX REV. 9 (2005).

[57] *Id.* at 14.

[58] *See* ORGANIZATION FOR ECON. CO-OPERATION AND DEV., HARMFUL TAX COMPETITION: AN EMERGING GLOBAL ISSUE (1998), available at http://www.oecd.org/dataoecd/33/0/1904176.pdf. *See also Communication from the Commission to the Council and the European Parliament: A Package to Combat Harmful Tax Competition in the European Union,* COM (1997) 564 final (May 11, 1997). William W. Bratton & Joseph A. McCahery, *Tax Coordination and Tax Competition in the European Union: Evaluating the Code of Conduct on Business Taxation*, 38 COMMON MKT. L. REV. 677 (2001) (comparing the virtues of tax competition with tax coordination).

[59] *See, e.g.,* Inman & Rubenfeld, *supra* note 32 (arguing that the "case for centralized fiscal policies in open public economies is clear").

[60] *Id.* at 656.

[61] *Id.* at 654-5.

[62] *See, e.g.,* William W. Bratton and Joseph A. McCahery, *Tax Coordination and Tax Competition in the European Union: Evaluating the Code of Conduct on Business Taxation*, 38 COMMON MKT. L. REV. 677, 690-702 (2001) (comparing economic arguments for tax competition and tax coordination in the U.S. and EU).

level of government best suited to levy certain taxes and supply certain public goods—are crucial in any integrated federal economy.[63]

Whether viewed as the result of a lack of EU-wide political consensus or as a policy decision to promote decentralized taxation, retention of income tax sovereignty by the member states has resulted in significant disparities among European tax systems. In a recent opinion, Advocate General Léger noted that:

> in the absence of Community harmonisation it must be accepted that there is competition between the tax regimes of the various Member States. That competition, which is reflected in particular by great disparity between the Member States in the rates of taxation of company profits, may have a significant impact on the choice of location made by companies for their activities in the European Union. It may be regrettable that competition operates between the Member States in this field without restriction. That is, however, a political matter.[64]

Depending on the circumstances, disparities between national tax systems may provide incentives or disincentives for cross-border activity.[65] For example, when a member state exempts its residents' foreign business income from taxation, it thereby encourages them to invest in foreign countries with lower national tax rates, but discourages them from investing in countries with higher national tax rates. A particular economic actor may end up in a better or

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[63] *See generally* McLure, *supra* note 48.

[64] Case C-196/04, Cadbury Schweppes plc v. Comm'rs of Inland Revenue, 2006 E.C.R. ___ (May 2, 2006) (opinion of Advocate General Léger), ¶ 55 *available at* http://curia.europa.eu/en/content/juris/index.htm (search for "Case C-196/04") (citation omitted). 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 1, 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.

[65] According to the Court:

> [T]he Treaty offers no guarantee to a citizen of the Union that transferring his activities to a Member State other than that in which he previously resided will be neutral as regards taxation. Given the disparities in the tax legislation of the Member States, such a transfer may be to the citizen's advantage in terms of indirect taxation or not, according to circumstances.

Case C-403/03, Schempp v. Finanzamt München V, 2005 E.C.R. I-06421, ¶ 45 (citing Case C365/02 Lindfors, 2004 E.C.R. I-7183, ¶ 34).

worse position than it would have experienced in an entirely domestic situation—it depends on the comparative tax rates.[66]

Disparities that lead economic actors to make tax-motivated decisions about where to locate investment are inefficient and pose an obstacle to full integration of the European market.[67] However, as long as direct tax sovereignty remains the domain of the member states, the ECJ has no jurisdiction to eliminate distortions arising from disparities. A particular distortion may discourage (or encourage) cross-border activities, but no one state can be said to be at fault for a disparity.[68] Indeed, the key feature distinguishing disparity from discrimination is that discrimination "occurs as the result of the rules of just one tax jurisdiction," whereas a disparity results from the interaction of laws of more than one jurisdiction.[69] Thus, while the ECJ can

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[66] Under an exemption system, the "home" state would exempt income earned abroad. Suppose Mr. Miller is a resident of a country called Home, which exempts foreign income and has a 30% tax rate. Miller has $1000 of income arising from each of Home State, Low State (20% tax rate), and High State (50% tax rate). Miller would pay $300 in tax to Home, $200 to Low, and $500 to High. Therefore, Miller has a tax incentive to invest in Low, as compared with Home and High. Exemption facilitates capital import neutrality, the notion that investment in a country should bear the same rate of tax, no matter where the investors reside. Exemption is commonly used in continental Europe and contrasts with the credit method frequently employed by the common law states including the United States and United Kingdom. Under the credit method, foreign income is included along with domestic income in taxable income in the home state. If Home were a credit county, it would tax Miller on the $1000 earned in Home at 30%, for a tax of $300. But Home would also tax the $1000 earned in Low at 30%, resulting in another $300 of tax. Home would credit the $200 of tax Miller paid to Low, leaving $100 of residual tax due to Home. This removes Miller's tax incentive to invest in Low, as compared with Home. By removing the incentive to invest abroad, Home pursues capital export neutrality. Under capital export neutrality, all investment from a particular country bears the same rate of tax, wherever it is invested. Home would tax the income Miller earns in High at 30% as well, for a third tax of $300. Against the tax due, Home would offer a credit for the tax Miller paid to High, but that credit may be limited to the $300 tax due on the income in Home. Thus, of the $500 tax paid to High, usually only $300 would be creditable in Home. For this reason, Miller might still have reason to avoid investment in High, and therefore credit systems that include limitations do not achieve capital export neutrality with respect to higher tax countries. This example vastly simplifies both exemption and credit systems, in particular by ignoring cross-crediting issues. *See generally* AULT & ARNOLD, *supra* note 9.

[67] *See* Part I.A, *infra*.

[68] *See* Case C-374/04, Test Claimants v. Comm'rs of Inland Revenue (Feb. 23, 2006) (opinion of Advocate General Geelhoed), http://curia.europa.eu/en/content/juris/index.htm (search for "Case C-372/04"), ¶¶ 37-39 (arguing that disparity cases are non-justiciable by the ECJ).

[69] *Id.* ¶ 46. The topic of market access restrictions, in which a member state bars non-nationals access to its domestic market, or bars its own nationals access to foreign markets, is not the topic for this Article. The Court has employed the language of restriction in some tax cases (fifteen of the forty-nine cases considered for this Article), but this Article focuses on the methodology used in discrimination cases. The Court has not clearly distinguished between restriction and discrimination in direct tax cases. *See* Axel Cordewener, *The Prohibitions of Discrimination and Restriction Within the Framework of the Fully Integrated Internal Market, in* EU FREEDOMS AND TAXATION 27 (Frans Vanistendael ed., IBFD 2006) (pointing out that "a vast number of decisions using the term "restrictions" in substance actually dealt with discriminatory national measures"). Cordewener concludes that "restriction" is "an *absolute* concept that operates autonomously… and can be applied without taking the (hypothetical) treatment of equivalent purely domestic transactions into account.") *Id.* at 26. *See also* Graetz & Warren, *supra* note 2, at 1199; Mason, *supra* note 2, at 91-95; Frans Vanistendael, *The Compatibility of the Basic Economic Freedoms with the Sovereign National Tax Systems of the Member States*, 12 EC TAX REV. 136, 137-8 (2003).

review and eliminate discriminatory tax measures that violate the EC Treaty, it must uphold non-discriminatory disparities.[70]

A convenient way to think about the role of EC law in member state tax systems is that it promotes horizontal equity in the cross-border context, but says nothing about vertical equity.[71] Horizontal equity is the notion that similarly-situated taxpayers should be treated the same, and the ECJ often articulates the non-discrimination standard as one that requires similar treatment for similar taxpayers.[72] In contrast, determinations about vertical equities are left to the democratic processes in the member states. Vertical equity refers to the notion that there may be reasons to treat taxpayers at different income levels differently—for example, a country may conclude that higher income taxpayers should pay more tax as a proportion of their income than do lower income taxpayers. Member states may not violate horizontal equity in the cross-border context. But as long as they treat cross-border situations the same as internal situations, they face no constraints on what that treatment must be. Vertical equity judgments about tax rates, degree of progressivity, personal exemptions, and so on, are made at the member state level, but once made, those judgments must be applied with equal force to both internal and cross-border situations.

TAX DISCRIMINATION METHODOLOGIES IN THE U.S. & EU

U.S. Supreme Court: The Internal Consistency Test (ICT)

Although the U.S. Constitution does not contain explicit free trade provisions comparable to the EC fundamental freedoms, the Supreme Court has held that the dormant Commerce Clause prohibits states from imposing taxes that discriminate against or unduly burden interstate

[70] *See* Case C-336/96, Gilly v. Directeur des services fiscaux du Bas-Rhin, 1998 E.C.R. I-2793. *See also* Weber, *supra* note 2, at 586. The U.S. Supreme Court makes a similar distinction between prohibited discrimination and permissible disparity. *See, e.g.,* Moorman Manufacturing Co. v. Bair, 437 U.S. 267 (1978) and discussion *infra* Part V.D.

[71] For horizontal and vertical equity considerations in tax policy, see generally LIAM MURPHY & THOMAS NAGEL, THE MYTH OF OWNERSHIP: TAXES AND JUSTICE 12-39 (2002).

[72] Case C-279/93, Finanzamt Köln-Altstadt v. Schumacker, 1995 E.C.R. I-225, ¶¶ 24, 30.

commerce.[73] For example, the Court held that a state discriminated against interstate commerce when it taxed domestic companies at a lower rate than out-of-state companies.[74] In the personal income tax area, the Supreme Court has also invalidated state tax provisions inconsistent with the Privileges and Immunities Clause.[75] The Court interprets these clauses to embody many of the same goals as the EC fundamental freedoms, including protection of the common market and promotion of the free flow of persons and commerce across state lines.[76]

Thus, it is not surprising that the ECJ and U.S. Supreme Court have come to similar decisions on factually similar tax discrimination cases.[77] For example, both courts have held that:

- Host states must allow as a deduction expenses related to the generation of host-state taxable income, but host states need not allow unrelated expenses[78]
- Host states may not categorically deny non-resident individuals the benefit of deductions for personal expenses or exemptions[79]
- Host states must grant tax advantages to charities that benefit out-of-state residents on the same basis as charities that benefit in-state residents[80]

The similarity of their decisions derives from the Courts' similar conceptions of tax discrimination: since both Courts see the anti-discrimination norm as protecting the functioning of the common market, both find discrimination whenever a state treats cross-border activity

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[73] *See* 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 the standard of review for state taxes under the Commerce Clause).

[74] *See, e.g.,* Metropolitan Life Ins. Co. v. Ward, 470 U.S. 869 (1985) (ultimately finding no violation of the Commerce Clause because Congress consented to the discrimination).

[75] *See, e.g.,* Travis v. Yale & Towne Mfg. Co., 252 U.S. 60 (1920) (holding that a state violated the Privileges and Immunities Clause when it denied non-resident taxpayers personal exemptions available to resident taxpayers).

[76] 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.

H.P. Hood & Sons, Inc. v. Du Mond, 336 U.S. 525, 665 (1949).

[77] For detailed comparisons of U.S. and EU state tax discrimination cases, see Kaye *supra* note 8.

[78] *Compare* Shaffer v. Carter, 252 U.S. 37 (1920) *with* Case C-234/01, Gerritse v. Finanzamt Neukölln-Nord, 2003 E.C.R. I-5933 *and* Case C-250/95, Futura Participations SA & Singer v. Administration des Contributions, 1997 E.C.R. I-2471.

[79] *Compare Travis*, 252 U.S. 60, *with* Case C-279/93, Finanzamt Köln-Altstadt v. Schumacker, 1995 E.C.R. I-225.

[80] *Compare* Camps Newfound/Owatonna, Inc. v. Town of Harrison, 520 U.S. 564 (1997) *with* Case C-386/04, Centro di Musicologia Walter Stauffer v. FA München für Körperschaften, 2006 E.C.R. ___.

worse for tax purposes than similar domestic activities.[81] The EC Treaty, like the U.S. Constitution, does not expressly forbid tax discrimination. Instead, EU nationals' fundamental economic freedoms to work, invest, and establish business across member states borders has been interpreted to include freedom from tax discrimination.[82] According to the Court of Justice, a member state commits tax discrimination when it treats similar tax situations differently (or different tax situations the same) based on a criterion, such as tax residence, that is likely to disadvantage non-nationals.[83] Put another way, U.S. states and EU member states may not use their tax systems to favor domestic commerce over interstate or inter-Community commerce.

If the anti-discrimination norm In the U.S. and EU forbids tax preferences for internal situations, how should the Courts evaluate whether such preferences exist? The Supreme Court has rendered tax judgments under the Commerce Clause since the late 1800s, applying a variety of overlapping and inconsistent standards and methods.[84] Those familiar with state taxation may be amazed at the claim that anything of value could be wrested from the U.S. Supreme Court's state tax jurisprudence, which by the Court's own description is a "quagmire" and "tangled underbrush."[85] However, the ECJ should take a closer look at a little-used U.S. methodology developed in the 1980s: the internal consistency test.[86]

Like the EU member states, U.S. states retain a large measure of tax autonomy. They are not required to adopt the best or least restrictive tax rule, or even the rule adopted by nearly all of other states.[87] However, the U.S. states may not discriminate against or unduly burden interstate commerce. In *Moorman Manufacturing*, a taxpayer raised a Commerce Clause challenge against Iowa's method of apportioning taxable income earned by a multi-state enterprise.[88] The portion of a company's multi-state income taxable in Iowa was determined by multiplying its overall

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[81] *See* Enrich, *supra* note 39, at 432 (U.S. state tax discrimination is evaluated by "purposes and effects"). *Cf.* Alvin C. Warren, Jr., *Income Tax Discrimination Against International Commerce*, 54 TAX L. REV. 131, 149-158 (2001) (international tax discrimination may occur when a country favors domestic producers, production or products).

[82] See, e.g., Case 270/83, Comm'n v. France (*avoir fiscal*), 1986 E.C.R. 273.

[83] Case C-279/93, Finanzamt Köln-Altstadt v. Schumacker, 1995 E.C.R. I-225, ¶ 30.

[84] See generally, HELLERSTEIN & HELLERSTEIN, *supra* note 6, ¶¶ 4.8 to 4.12 at 4-23 to -68.

[85] Northwestern States Portland Cement Co. v. Minnesota, 358 U.S. 450, 457-8 (1959). *See also* Wardair Canada Inc. v. Florida Dept. of Revenue, 477 U.S. 1, 17 (1986) (Burger, C. J., concurring in part and concurring in judgment) (referring to "the cloudy waters of this Court's 'dormant Commerce Clause' doctrine").

[86] Internal consistency was first articulated by the Supreme Court in Container Corp. of Am. v. Franchise Tax Bd., 463 U.S. 159, 169 (1983).

[87] *See, e.g.,* Moorman Manufacturing Co. v. Bair, 437 US 267 (1978) (holding that a state was free to adopt an apportionment formula that differed from the formula used by forty-four of the forty-six states imposing an income tax).

[88] *Id*.

income by a fraction equal to the enterprise's Iowa sales over its overall sales.[89] Moorman argued that this "single-factor sales" formula was duplicative considering that almost all the other states, including Moorman's home state of Illinois, used the so-called "Massachusetts formula," which equally weighed sales, property, and payroll.[90] Moorman argued that mismatches of apportionment formulas could lead to over-taxation.[91] The Supreme Court, reluctant to evaluate the comparative merits of single-factor sales and the Massachusetts formula, concluded that even if single-factor sales resulted in "some overlap" with Illinois' formula, it was not clear that "Iowa, rather than Illinois, was necessarily at fault *in a constitutional sense*."[92] 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.[93]

According to the Court, uniformity should be imposed by Congress, not the courts.[94]

Building on *Moorman,* the Supreme Court developed ICT to evaluate state apportionment formulas. The Court began to ask: If all fifty states adopted the challenged formula, would multiple taxation inevitably result?[95] If so, the apportionment rule was invalid. Consider the

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[89] *Id*. at 270.

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

[91] *Id.* at 276-277.

[92] *Id.* at 277 (emphasis added). One criticism that could be lodged against the Court's ruling in *Moorman* is that it focused too much on discrimination, and not enough on whether Iowa's rule created an "undue burden" on interstate trade in light of the near-universal adoption of a contrary standard by the other states. *Compare* Bibb v. Navajo Freight Lines, Inc., 359 U.S. 520 (1959) (invalidating a non-discriminatory state mudguard regulation that differed from the mudguard regulation of forty-five other states).

[93] *Moorman* at 278, n. 12.

[94] "It is to that body, and not this Court, that the Constitution has committed such policy decisions." *Id.* at 280.

[95] 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. This test asks nothing about the economic reality reflected by the tax, but simply looks to the structure of the tax at issue to see whether its identical application by every State in the Union would place interstate commerce at a disadvantage compared with intrastate commerce. A failure of internal consistence shows as a matter of law that a State is attempting to take more than its fair share of taxes from the interstate transaction, since allowing such a tax in one State would place interstate commerce at the mercy of those remaining States that might impose an identical tax.

formula used by Iowa in *Moorman*. If every state adopted single-factor sales, all of Moorman's multi-state income would be taxed once, and only once. If Iowa's deviation from the Massachusetts formula resulted in double taxation for Moorman, that double tax would result from disparities, not unconstitutional discrimination. Contrast a formula that apportioned income based on sales made in *other states*. Under the harmony constraint, multiple taxation would inevitably arise as each state sought to tax the sales taking place in the other forty-nine states.

The Supreme Court does not frequently employ ICT because that test is subsumed by other constitutional standards, including the "undue burden" test under the Commerce Clause, and the concept of "fair apportionment" of state taxes under Due Process.[96] However, there is no conceptual reason why ICT should not be used to evaluate substantive tax provisions, in addition to apportionment formulas.[97] The principle virtue of ICT is that under the harmony constraint it becomes possible to determine with certainty that preferences for internal economic activities are due to the defendant state's laws alone, rather than the interaction of the laws of the defendant state and other states. Confirmation that the internal preference (or cross-border disadvantage) is not the result of disparity is particularly helpful in the EU, where disparities are exacerbated by the lack of a common federally-defined tax base.[98]

ECJ: The Comparable Internal Situation Test (CIST)

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 for interstate bus travel). Internal consistency was developed by the Supreme Court in evaluating apportionment claims under the Commerce and Due Process Clauses. *Id.*

[96] *See* Walter Hellerstein, *Is "Internal Consistency" Foolish?: Reflections on an Emerging Commerce Clause Restraint on Taxation*, 87 MICH. L. REV. 138 (1988) (arguing that internal consistency did not add anything to the Supreme Court's preexisting jurisprudence requiring state taxes to be fairly apportioned). This criticism does not apply in the EU context because member states use source and residence rules and separate accounting to determine direct tax liability, rather than using U.S.-style formulary apportionment.

[97] The Supreme Court has applied ICT to substantive taxes. *See, e.g.,* Armco Inc. v. Hardesty, 467 U.S. 638 (1984) (striking down wholesaling tax that exempted in-state manufacturers); American Trucking Ass'ns v. Scheiner, 483 U.S. 266 (1987) (striking down a flat axle tax applied to trucking in Pennsylvania as internally inconsistent because if it were adopted by all fifty states, interstate truckers would be subject to cumulative burdens, while in-state truckers would not). Recently, the Supreme Court narrowed the application of the internal consistency test by ruling that it did not apply to "local" taxes. *See* American Trucking Ass'ns, Inc. v. Michigan Public Serv. Comm'n, 545 U.S. 429, (2005). *See generally* HELLERSTEIN & HELLERSTEIN, *supra* note 6, ¶ 4.15.

[98] See citations *supra* note 47. There are proposals in the EU for a limited consolidated corporate tax base with formulary apportionment. *See 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).

A taxpayer who believes he or she has been taxed in a manner that violates the EC Treaty has the right to sue in national court for enforcement of the Treaty.[99] If the national court is uncertain about the application of EC law to the situation, it may ask the ECJ for a preliminary ruling on the interpretation of EC law.[100] The ECJ's ruling does not dispose of the case before the national court; rather it provides a binding interpretation of EC law on the questions referred. The rulings of the ECJ bind not only the referring court, but all national courts for the matter in question. The vast majority of income tax cases arrive in the ECJ as requests for preliminary ruling.[101] In an effort to systematically analyze the ECJ's approach in tax discrimination cases, I examined all 112 cases decided by the Court from 1983 to the end of 2005 cataloged in the European Commission's Taxation and Customs Union Directorate General's list of "cases of particular interest for direct taxation."[102] The list was narrowed to the forty-nine cases decided on the merits that involved a complaint of discrimination with respect to direct taxation.[103] Interestingly, although many ECJ tax discrimination cases involve allegations by non-resident taxpayers against host member states, more than half the cases involved allegations that a member state discriminated against its own resident because of the resident's cross-border activity.[104]

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[99] *See, e.g.,* Joined Cases C-397/98 & C-410/98, Metallgesellschaft Ltd v. Comm'rs of Inland Revenue, 2001 E.C.R I-1727, ¶¶ 98-107.

[100] EC TREATY, *supra* note 1, art. 234. Lower national courts may refer unclear EC law questions to the ECJ, and national courts of last resort must do so. *Id.* No reference need be made if the correct application of EC law is obvious. Case C-283/81 CILFIT v. Ministry of Health, 1982 E.C.R. 3415. For more on Court procedure, see MASON, PRIMER, *supra* note 7, at 15-21.

[101] In a few tax cases the European Commission exercised its right under Article 226 to sue a Member State for failure to fulfill a treaty obligation. *See, e.g.,* Case C-270/83, Commission v. French Republic (Avoir Fiscal), 1986 E.C.R. 273.

[102] European Commission, ECJ Cases in the Field of, or of Particular Interest for, Direct Taxation, Oct. 27, 2006, available at http://ec.europa.eu/taxation_customs/resources/documents/taxation/gen_info/tax_law/legal_proceedings/court_cases_direct_taxation_en.pdf (hereinafter DG Tax List).

[103] This means, for example, that cases involving value-added taxes or purely procedural issues were not considered. For details on the methodology used, see *Notes on the Coding Protocol for CIST Study* (Feb. 15, 2007) (on file with the author) [hereinafter *Coding Notes*]. For the raw data, see *CIST Study* (Feb. 15, 2007) (on file with the author).

[104] Twenty-four cases involved complaints of discrimination against non-resident taxpayers, and twenty-seven cases involved complaints that a member state discriminated against its own tax resident. These figures do not sum to forty-nine because multiple claims were made in a few cases. For example, cases involving the freedom to provide services implicate both the service provider's and the service recipient's rights. The provider and recipient generally reside in different states. The prevalence of claims by taxpayers against their own residence state is somewhat surprising because it suggests that residents' ability to vote in a member state may be insufficient protection against tax discrimination. *See supra* Part I.B. One explanation may be that tax residents are not necessarily qualified to vote in their tax residence state. Familiarity of the legal system and absence of language barriers may also result in a more challenges by taxpayers of their own tax residence state than host states. For a

The cases follow a general pattern: a member state penalizes a non-resident taxpayer (or a resident taxpayer with cross-border economic activities) in a case where there would be no penalty in a purely domestic situation. Most countries tax on the basis of residence, rather than nationality.[105] Unlike nationality discrimination, residence discrimination is not expressly prohibited by the EC Treaty, but the ECJ has found that since residence and nationality tend to overlap, differential treatment of non-residents raises concerns about "covert" nationality discrimination.[106] The ECJ is generally unconcerned with the intent of the national legislature to discriminate; if the Court perceives that the tax is likely to discourage cross-border economic actors in comparison with similarly situated internal actors, it will declare the law discriminatory.[107] However, not every difference in treatment is discriminatory. Worse treatment for a cross-border situation is only discriminatory when the cross-border situation is "similar" to a purely domestic situation, such that there is no justification for treating the two situations differently.[108] Determining whether an internal and a cross-border situation are "similar" is thus a necessary step for evaluating tax discrimination cases, and it is the purpose of CIST.

Comparing Attributes

Biehl v. Administration des Contributions de Luxembourg demonstrates the application of CIST.[109] Biehl was a German national who resided and worked in Luxembourg from January to October 1983.[110] His Luxembourg employer withheld too much tax from his wages, but Luxembourg refused to refund the overpayment unless Biehl participated in an administrative

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case in which a tax resident complained of discrimination by her home state, see Case C-336/96, Gilly v. Directeur des services fiscaux du Bas-Rhin, 1998 E.C.R. I-2793 (challenging home state's foreign tax credit limitation).

[105] This is true of most EU countries, whereas the United States is alone in its use of citizenship as a basis for individual taxation. Likewise, the United States is unusual because it uses place of incorporation, rather than place of management and control, as a basis for corporate tax. *See generally,* AULT & ARNOLD, *supra* note 9, at 347-350 (2004). Under EC law, a corporation is considered to be a national of the member state in which it has its corporate seat. EC Treaty, *supra* note 1, art. 48.

[106] Case C-279/93, Finanzamt Köln-Altstadt v. Schumacker, 1995 E.C.R. I-225, ¶¶ 27-29.

[107] *See, e.g.,* Case C-330/91, Queen v. Inland Revenue Comm'rs, *ex parte* Commerzbank AG, 1993 E.C.R. I-4017, ¶ 15 (holding that the challenged tax rule was "liable to work more particularly to the disadvantage" of non-residents).

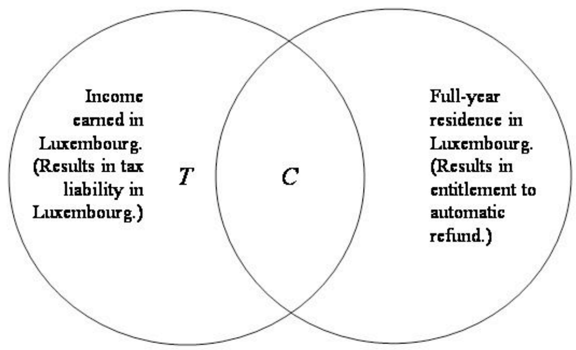
[108] Case C-279/93, Finanzamt Köln-Altstadt v. Schumacker, 1995 E.C.R. I-225, ¶ 24.

[109] Case C-175/88, Biehl v. Administration des Contributions de Luxembourg, 1990 E.C.R.I-1779.

[110] *Id.* ¶¶ 3, 4.

procedure. In contrast, full-year residents were entitled to automatic refunds.[111] Since Biehl moved back to Germany in November of 1983, he was ineligible for an automatic refund.[112] The argument that Biehl should be entitled to an automatic refund relied on Biehl's assertion that he was similar to a full-year Luxembourg resident taxpayer. We could formalize the comparison urged by Biehl in a Venn diagram, as follows:

Figure 1: Comparison of Two Attributes



In the diagram, Taxpayer, *T*, like Biehl, is a partial-year resident of Luxembourg, who is ineligible for an automatic refund. *T's* situation can be compared with Comparable, *C*, a full-year Luxembourg resident entitled to an automatic refund. If these were the only two attributes compared, then the only difference between *T* and *C* would be that *T* is denied an automatic refund. The ECJ would presumably judge *T* and *C* to be similarly situated, which in turn would lead to the conclusion that treating them differently for refund purposes violates EC law.

In contrast, Luxembourg argued that the Court should take another relevant tax attribute into consideration: "salary splitting."[113] Taxpayers who earn income in more than one country with progressive tax rates are able to "split" their income over two or more states, thereby subjecting more of their income to lower tax brackets. Taxpayers able to split their salaries may pay less tax overall than taxpayers earning the same dollar amount of income all in one state.[114] Thus,

[111] *Id.* ¶¶ 5, 17-18. Tax is likely to be over-withheld on partial-year residents in a progressive tax system, since the determination of the withholding amount is generally made on the assumption that the taxpayer will reside in the state for the full year.

[112] *Id.* ¶¶ 3, 7. The ECJ held that an administrative procedure designed for non-residents to secure tax refunds was inadequate because the tax administration was not required to refund the taxes in every discriminatory case. *Id.* ¶¶ 17-18.

[113] *Id.*¶ 15.

[114] The advantage of salary splitting can be demonstrated with a simple example involving just two jurisdictions with identical progressive tax systems. Both countries exempt the first $10,000 of income, tax the next $20,000 at 10%, and tax any amounts over $30,000 at 50%. Compare two taxpayers, one of whom earns $100,000 in a single jurisdiction, while the other earns $50,000 in each jurisdiction:

Luxembourg argued that the administrative refund procedure was crucial to protecting its progressive tax system.

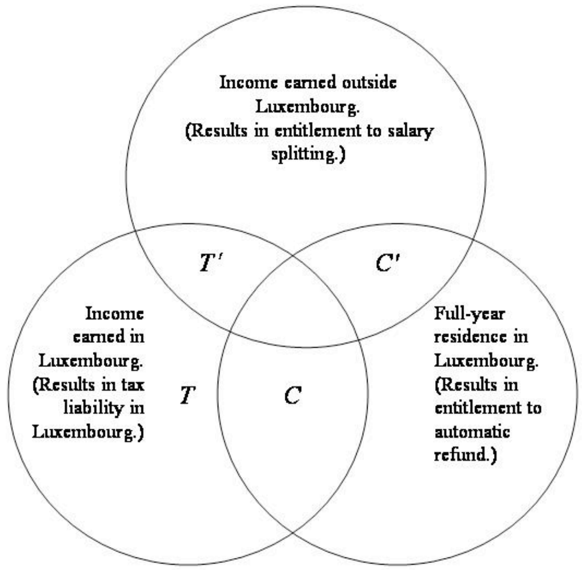
In Luxembourg's view, a partial-year resident is not similarly situated to a full-year resident because partial year residents have the advantage of salary splitting. It argued that *C*, the full-year Luxembourg resident entitled to an automatic refund, should be compared with *T′*, a partial-year resident earning only *part* of his income in Luxembourg and entitled to salary splitting. Luxembourg's comparison between *T′* and *C* could be formalized as follows:[115]

Table A. Income Splitting

	Single Jurisdiction	Two Jurisdictions	
Income	$100,000	$50,000	$50,000
Tax on $0 - $10,000 (exempt)	0	0	0
Tax on $10,000 - $30,000 taxed (10%)	2,000	2,000	2,000
Tax on amounts over $30,000 (50%)	35,000	10,000	10,000
Total tax paid	$37,000	$24,000	

[115] *Biehl*, ¶ 15.

Figure 2: Comparison of Three Attributes



Although *T′* and *C* share one attribute (income earned in Luxembourg), they do not share another relevant attribute (income earned outside of Luxembourg). Since the taxpayers have different tax attributes, Luxembourg argued they were not similarly situated, and therefore could be treated differently for refund purposes. In contrast, under Biehl's proffered comparison, *T* and *C* appear to be similarly situated.

The facts of the case do not reveal whether Biehl actually benefited from income-splitting, so it is difficult to know which pair of hypothetical taxpayers to compare. However, the Court adopted Biehl's view and compared full- and partial-year taxpayers, *both of whom earned all their income in Luxembourg*.[116] Because these two sets of taxpayers were similarly situated, Luxembourg could not treat them differently without violating the freedom of movement of workers.[117] The ECJ held that although the refund rule applied irrespective of nationality, there was a risk that it would "work in particular against taxpayers who are nationals of other member states," because non-nationals were more likely to be only partial-year residents.[118]

There was nothing inevitable about the Court's choice of *T* and *C* for comparison, rather than *T′* and *C*. Indeed, the Court's assumption that a partial-year resident would earn all of his income in the host state was contrary its assertion that resident and non-resident taxpayers are

[116] *Id.* ¶ 16. The Court also considered other attributes, but this was the decisive comparison. *Id.* ¶¶ 15-16,
[117] *Id.* ¶¶ 12, 20.
[118] *Id.* ¶ 14.

not usually similarly situated for tax purposes, precisely because non-residents do not generally earn the majority of their income in the host state.[119] If the Court usually assumes that taxpayers earn most of their income in their home state, why did it assume that a partial-year resident would earn 100% of his income in the host state?[120] One thing is clear: choosing this comparison dispatched Luxembourg's principle justification for its differential refund policy.

How should the Court's ruling in *Biehl* be evaluated? The discrimination in this case seems relatively obvious: full-year residents are entitled to a preferential refund procedure compared to non-residents. A tax disadvantage is imposed on taxpayers with attributes more likely to be possessed by cross-border than purely domestic economic actors. Therefore, using CIST the Court came to the correct conclusion: the difference in treatment was discriminatory. But CIST allows for comparisons (such as *T′* and *C*) under which the non-resident taxpayer's disadvantage from the contested tax provision is compensated by preferential treatment available from another member state, such as salary splitting. The Court ordinarily refuses to consider such offsetting benefits, unless the benefit and the detriment are clearly linked.[121] Unfortunately, the Court is not always successful in discerning when a tax advantage and disadvantage are linked, and using a test such as CIST that relies on comparisons between cross-border and internal situations is not likely to avoid such errors.[122] As will be shown, imposition of the harmony constraint under ICT prevents consideration of offsetting benefits available under the law of other member states.

Additionally, the choice of attributes to be compared under CIST, although decisive, is not obvious. Indeed, perhaps neither the comparison urged by Biehl and adopted by the Court, nor the comparison urged by Luxembourg is correct. Perhaps *T′*, the taxpayer earning only part of his income in Luxembourg and denied an automatic refund because he was only resident in

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[119] *See, e.g.,* Wielockx v. Inspecteur der Directe Balastingen, 1995 E.C.R. I-2493, ¶ 20; Case C-279/93, Finanzamt Köln-Altstadt v. Schumacker, 1995 E.C.R. I-225, ¶ 32. In contrast, the Supreme Court considered it "rash" to assume that a non-resident taxpayer has income outside the host state. Travis v. Yale & Towne Mfg. Co., 252 U.S. 60, 81 (1920).

[120] The Advocate General for the case urged the Court to compare full- and partial-year residents with 100% of their income in Luxembourg. Case C-175/88, Biehl v. Administration des Contributions de Luxembourg, 1990 E.C.R. I-1779, ¶ 11 (Jan. 24, 1990) (opinion of Advocate General Darmon).

[121] *See, e.g.,* Case 270/83, Comm'n v. France (*avoir fiscal*), 1986 E.C.R. 273 (holding that France's denial of imputation credits to non-resident shareholders could not be compensated by the availability in France of tax advantages to non-residents, such as exemption from formation taxes); Case C-294/97, Eurowings Luftverkehrs AG v. Finanzamt Dortmund-Unna, 1999 E.C.R. I-7447 (holding that a tax disadvantage in the host state could not be compensated by an unrelated tax advantage available to the non-resident taxpayer in its host state). *Cf.* Case C-204/90, Bachmann v. Belgium, 1992 E.C.R. I-249 (holding that a disadvantage was permissible because it was offset by a related tax advantage).

[122] *See* discussion *infra* notes 142 to 145 and accompanying text.

Luxembourg for part of the year, should have been compared with *C′*, a taxpayer earning only part of his income in Luxembourg, but nevertheless entitled to an automatic refund because he was resident in Luxembourg for the full year (see *Figure 2*, above). This comparison would lead to the conclusion that *T′* and *C′* were similarly situated: since both were taxable in Luxembourg and both had access to salary splitting, Luxembourg would have to treat them the same.

Endless comparisons can be made with respect to any given case. Irrelevant comparisons would make taxpayers vacuously comparable: comparing taxpayers with respect to how many eyes they have would make almost all taxpayers similarly situated, no matter how different their tax situations. Conversely, comparing taxpayers with respect only to the contested tax provision would make them vacuously incomparable. For example, Biehl would never be similarly-situated to full-year residents, no matter how similar their actual tax situations, if Biehl and full-year residents were only compared with respect to entitlement to receive an automatic refund. They would always be different, because a full-year resident is entitled to the automatic refund, while Biehl is not. This phenomenon points to a circularity in CIST: similarly situated taxpayers must be treated similarly, but differently-situated taxpayers may be treated differently. Could the contested difference in tax treatment itself make two taxpayers incomparable?

Perils of Looking Across Borders

Questions fundamental to the application of CIST abound. What does it mean for two taxpayers to be comparable? How similar must they be before they warrant equal treatment? With respect to what attributes should the similarity be measured? As the number of attributes considered by the Court rises, so does the complexity of the analysis.[123] In the forty-nine cases

[123] Given the assumptions below, the number of possible outcomes of a comparison between two taxpayers is exponential in the number of attributes considered (3^a, where *a* is the number of attributes). In a simple comparison of two attributes, like the one performed by the Court in *Biehl,* there were nine possible outcomes:

Table B. Possible Intersections of Two Attributes

			C's Truth Values			
	Attribute 1 (Taxable in Luxembourg)		T	T	F	F
		Attribute 2 (Entitled to Automatic Refund)	T	F	T	F
T′	T	T	*1*	*2*	*3*	*4*

considered for this Article, the average number of attributes considered by the Court per case was two. Although the Court considered as many as six attributes in a single case, in eighteen out of the forty-nine cases, only one attribute was considered.[124] The most frequently compared attribute by far was tax base, followed by the nature of the taxpayer's economic activity, the portion of income sourced in the host state, and progressivity issues (such as ability to pay).[125] The term "tax base" refers to how the country defines taxable income: what the country chooses to tax, and what it chooses to exclude or deduct.

To get a sense of how complicated the comparability analyses becomes in light of differences in tax base between the host and home state, consider the *Bachmann* case.[126] Bachmann was a German national working in Belgium and insured by a German insurance company.[127] Under Belgian law, life insurance premiums were deductible, but only if paid to Belgian insurers.[128] Belgium argued that the difference in treatment of premiums was justified because, although it denied deductions for premiums paid to foreign insurers, it also exempted from tax insurance awards paid by foreign insurance companies.[129] In contrast, awards paid on Belgian life insurance contracts were taxable to the insured.[130] In answer to this justification, the Court of

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T	F	*5*		*6*	
F	T	*7*	*8*		
F	F	*9*			

This formula assumes that: (1) attributes are binary in nature: either the taxpayer possesses the attribute (truth value T) or the taxpayer does not (truth value F); (2) the Court will not consider any attribute possessed by neither taxpayer (this provides for three possible configurations of taxpayers for each attribute: either one or the other or both possesses it, yielding 3^a); (3) the Court will continue its practice of comparing only two taxpayers at a time.

[124] The incidence of consideration of particular attributes in the cases considered for this Article were as follows: zero attributes were considered in 5 cases, one attribute in 18 cases, two attributes in 14 cases, three attributes in 2 cases, four attributes in 4 cases, five attributes in 2 cases, and six attributes in 4 cases. Cases considering no attributes were generally decided on restriction grounds, notwithstanding the taxpayer's complaint alleging discrimination. *See, e.g.,* C-446/03, Marks & Spencer plc v. Halsey, 2006 E.C.R. I-10,837.

[125] Many cases considered more than one attribute. The number of cases considering each attribute was as follows: tax base (29), the nature of the taxpayer's economic activities (11), portion of income sourced in the host state (10) , progressivity (10), ability of the home state to grant the relief in question (9), taxpayer's personal or family circumstances (9), source of income (8), procedural requirements (4), entitlement to losses (4), length of residence (4), liquidity (3), achievement of host member state tax policy (1).

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

[127] *Id.* ¶ 2. Bachmann continued payments on sickness and invalidity insurance and life assurance policies he took out while still in Germany.

[128] *Id.* ¶ 3. The case also involved sickness insurance, an issue not considered here.

[129] *Id.* ¶ 10.

[130] *Id.* ¶ 22.

Justice raised the possibility that the worker's state of origin might tax the insurance award.[131] If Germany taxed Bachmann's insurance award, he would suffer a double detriment: taxation of the award by Germany and inclusion of the premiums by Belgium.

In order to apply CIST, first the attributes of the complaining taxpayer must be fixed. Bachmann was insured by a foreign insurance company, which triggered adverse tax consequences. But are there other relevant tax attributes that should also be considered by the Court? Suppose Bachmann lived in a simplified EU with only three states: Belgium, Germany, and Spain. Even in this simplified world, to account for the interaction of the defendant state's tax laws and those of other member states to which the taxpayer may retire, the Court faces a tremendous diversity of possible comparisons, only some of which are explored here.[132]

To begin with, should the Court assume that Bachmann will still reside in Belgium when he receives the insurance award, so that he will escape tax on the award? Would the Court have to verify that, under German law, the award would go untaxed if Bachmann remains in Belgium? Or should the Court assume that Bachmann will receive his insurance award after retiring to Germany? In that case, would tax of insurance proceeds under German law be relevant to the question of whether Belgium's statutory scheme is discriminatory? What if Bachmann plans to retire to Spain after working in Belgium? Will Spain tax the insurance award? The answer to that question might be found in the Spanish-German double tax treaty. Should the Court consult the tax treaty?

Unfortunately, the Court has not articulated a methodology for selecting among these possible situations, and as a result, it is difficult to predict the Court's analysis.[133] At times, the Court considers the law of the other member states only hypothetically, while in other cases it

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[131] *Id.* ¶ 11.

[132] Because there are at least six attributes to compare in this analysis, the Venn diagram is too complex to reproduce here. Mathematicians have considered the problem of representing the intersection of four or more sets with Venn diagrams, using shapes other than circles to represent the sets. *See, e.g.,* A.W.F. EDWARDS, COGWHEELS OF THE MIND: THE STORY OF VENN DIAGRAMS (2004).

[133] *See, e.g.,* Case C-42/02, Lindman, 2003 E.C.R. I-13,519. The complaining taxpayer was a Finnish resident who won a Swedish lottery. Finland taxed foreign, but not domestic, lottery proceeds. Lindman urged that her situation be compared with: (1) a Swedish resident winning a Swedish lottery, or (2) a Finnish resident winning a Finnish lottery. *Id.* ¶ 12. In either case, her winnings would be exempt. Without expressly rejecting Lindman's analysis, the Court instead compared a foreign lottery with a domestic lottery, shifting the analysis from the lottery customer to the lottery service provider. *Id.* at 21. Of course, many more potential comparisons could have been performed by the Court. *See* van Thiel, *supra* note 50, at 11-13 (concluding that the Court has "*generously allowed comparisons* to be made when establishing similarity" and noting that permissible comparisons under EC tax law are broader than under international tax non-discrimination principles) (emphasis in original).

looks at the actual law of other member states relevant to the case.[134] Still other times the Court holds that the tax consequences in other member states should not bear on the question of whether a particular member state has discriminated.[135] Notwithstanding the lack of clearly articulated standards for selecting pairs of taxpayers for comparison, assumptions related to taxpayers' attributes determine the outcome of the analysis under CIST. If Bachmann will not be taxed by any country on the insurance award, then deduction of the premiums in Belgium seems inappropriate.[136] In contrast, if Bachmann will be taxed on the insurance award, then the denial of the premium deduction in Belgium puts him in a worse position than a worker carrying Belgian insurance. Is it possible that Belgium's law could be EC-compliant with respect to workers retiring in Spain, but non-compliant with respect to workers retiring in Germany?

In addition to determining the relevant attributes of the complaining taxpayer, the Court must also select an internal situation for comparison. In Bachmann's case, is the appropriate comparable a life-long Belgian resident worker with Belgian insurance who deducts his premiums and includes his award? Or should we compare Bachmann with a Belgian-insured worker working abroad but retiring to Belgium, where he is taxed on his insurance award? If so, is it relevant whether the taxpayer was able to deduct his premiums while working abroad? What if the rules related to premium deduction are different in Germany and Spain? Do we again run the risk that Belgian law will be EC-compliant with respect to one country, but not with respect to the other? Perhaps Bachmann should be compared to a Belgian worker who retires to Germany or Spain? In that case, would the Court need to account for how Germany or Spain would tax the insurance proceeds? For example, is it relevant that, despite the deduction of premiums in Belgium, a Belgium-insured worker may be able to escape tax on the award by retiring to another country?

In *Bachmann*, the Court of Justice held that the differential treatment of premiums by Belgium indirectly discriminated on the basis of nationality. The Court compared a worker with Belgian insurance who deducted the premiums but was taxed on the award to a worker with foreign insurance who was not able to deduct the premiums, but was nevertheless taxed on the

[134] *Compare* Case C-204/90, Bachmann v. Belgium, 1992 E.C.R. I-249 (making the comparison under the *assumption* that Bachmann's home state will tax, without reference to actual German law) *with* Case C-319/02, Manninen, 2004 E.C.R. I-7477 (looking at the actual corporate tax rate in the other state in a case involving double economic tax relief on inbound dividends).

[135] Case C-294/97, Eurowings Luftverkehrs AG v. Finanzamt Dortmund-Unna, 1999 E.C.R. I-7447, ¶¶ 43-44.

[136] For example, suppose that Germany exempted insurance awards even if the premiums had been deducted in another country.

award when he returned to his state of origin.[137] The Court held that since non-Belgian nationals were more likely than Belgians to carry foreign insurance, the difference in treatment was discriminatory.[138] Despite the discrimination, the Court held that there was no violation of the EC Treaty because Belgium's insurance tax scheme was "fiscally coherent": if the premiums were deducted, the award was taxed, but if the premiums were included, the award was exempt.[139]

Again, there was nothing inevitable about the pair of taxpayers the Court chose to compare in *Bachmann*. Had the Court assumed that Bachmann would not be taxable on the insurance award—perhaps because his home state did not tax life insurance awards or because he would continue to reside in Belgium—it might have come to a different conclusion. Because selection of the pair for comparison is decisive, tax discrimination cases engender much controversy about the nature of the comparison to be performed under CIST.[140] It would be unreasonable to expect perfect predictability from any judicial standard. The argument in this Article, however, is that by using internal consistency to simplify its inquiry, the Court of Justice can achieve more accurate and predictable results.

Comparison of ICT & CIST

Since ICT and CIST both have the same goal—to identify cases of tax discrimination—application of each test to the same facts should lead to the same results. But ICT is easier to apply than CIST. If the ECJ applied ICT to *Biehl*, it would posit that all twenty-seven member states refused to refund over-withheld tax for partial year residents. Under the harmony constraint, it becomes obvious that all partial-year residents would be denied automatic refunds, no matter what their income splitting situation. In contrast, taxpayers living and earning income only in one state would never be adversely affected. Such disadvantageous treatment for cross-border situations compared with purely domestic situations is discriminatory. The ICT eliminates the need to take into account offsetting advantages available in the other member states, such as

[137] *Bachmann* ¶ 10.
[138] *Id.* ¶¶ 4, 9-11.
[139] *Id.* ¶¶ 21-28.
[140] *See infra* notes 224 to 226 and accompanying text.

salary splitting. The Court also avoids the challenge of choosing a comparable internal taxpayer for comparison.

Bachmann was a complicated case because it required the Court to contemplate the possibility that the complaining taxpayer would change his residence between the time he paid his insurance premiums and the time he received his insurance award. The diversity of possible tax treatments of the insurance award by the other member states created the risk that a defendant state's law would be EC-compliant with respect to workers from one member state, but non-compliant with respect to workers from another member state. By imposing the harmony constraint, ICT avoids the problem of having to determine: (1) the specific laws of the other member state, and (2) how those laws affect the complaining taxpayer.

Applying the harmony constraint in *Bachmann* would mean that every member state would have the same rule as Belgium: each would allow deductions for premiums paid to resident insurance companies and tax the insurance award, but deny deductions for premiums paid to foreign insurers and exclude the insurance award. If we assume that Bachmann bought insurance from a German insurance company, and worked in Belgium, there are three possible tax outcomes, depending on where he retires:

TABLE 1. GERMAN INSURANCE

Premium	Retirement to	Award	Layers of Tax
Included	Belgium	Excluded	1
Included	Germany	Included	2
Included	Other EU	Excluded	1

In contrast, workers in Belgium carrying Belgian insurance fare better under two out of three possible outcomes:

TABLE 2. BELGIAN INSURANCE

Premium	Retirement to	Award	Layers of Tax
Deducted	Belgium	Included	1

Deducted	Germany	Excluded	0
Deducted	Other EU	Excluded	0

Thus, ICT makes it clear that Belgium's rule is not internally consistent because domestic insurance is systematically preferred over foreign insurance. The Court needn't worry which of the above scenarios is most likely: because Belgium disadvantages some workers with foreign insurance over those with domestic insurance, Belgium discriminates.[141]

Although this Article focuses on the preliminary determination of the presence of tax discrimination, and does not deal with justifications for discrimination, it is appropriate to comment here that a finding of internal inconsistency should preclude a finding of that a member state's tax law is justified by the need to preserve the "fiscal coherence" of the tax system.[142] In *Bachmann* the Court held that the discrimination was justified by the need for fiscal coherence.[143] Appling CIST in *Bachmann*, the Court settled on a particular pair of taxpayers for comparison, thereby neglecting to take the full tax circumstances into account. The Court focused narrowly on the comparison of a foreign-insured worker who retired in Belgium with a domestically-insured worker who retired in Belgium.[144] Although the timing of these workers' tax liability in Belgium differed, they would each only suffer a single layer of tax in Belgium, which the Court judged to be fiscally coherent.[145] However, had the Court applied ICT and examined the other retirement scenarios, it would have seen the pervasive favoritism in the Belgian system for domestic insurance.

[141] The ECJ has never specifically enunciated the quantum of discrimination necessary for finding a violation of the EC Treaty, but its case law suggests that the threshold is quite low. *See, e.g.,* Case C-9/02, De Lasteyrie du Saillant v. Ministère de l'Économie, des Finances et de l'Industrie, 2004 E.C.R. I-2409 (holding requirement that taxpayer provide a guarantee for a discriminatory tax was itself discriminatory).

[142] For more on fiscal coherence, see MASON, PRIMER, *supra* note 7, at 94-101.

[143] Case C-204/90, Bachmann v. Belgium, 1992 E.C.R. I-249, ¶¶ 21-28.

[144] This comparison is represented by the first line of Tables 1 and 2, *supra* at page 33. Under this scenario, the German-insured and the Belgian-insured taxpayer were both subject to only one layer of tax. However, by choosing only this pair for comparison, the Court failed to notice that under any other comparison, the German-insured worker would fare worse than the Belgian-insured worker.

[145] The timing issue—the notion that deducting premiums and including the award may confer a timing advantage compared with including the premiums and excluding the award, was not considered by the Court, and is not considered here. For ECJ cases considering timing and liquidity issues, see, e.g., Joined Cases C-397/98 & C-410/98, Metallgesellschaft Ltd v. Comm'rs of Inland Revenue, 2001 E.C.R I-1727 (holding that differential entitlement to tax deferral was discriminatory) and Case C-9/02, De Lasteyrie du Saillant v. Ministère de l'Économie, des Finances et de l'Industrie, 2004 E.C.R. I-2409 (holding that a guarantee requirement for a discriminatory tax was itself discriminatory).

Application of ICT to *Biehl* and *Bachmann* demonstrates the principal advantages of ICT: it simplifies the comparison of the defendant state's tax treatment of the internal and the cross-border situation, and it relieves the Court of the duty to learn the actual laws of any member state other than the defendant member state. As will be shown in the next two Parts of this Article, introduction of these simplifications might prevent the Court of Justice from committing the errors of false discrimination and false disparity.[146] Part of the complexity in cross-border tax cases arises from the fact that two states' tax laws apply to the taxpayer simultaneously. A single taxpayer is subject to the source tax rules of the host member state and the residence tax rules of his or her home member state. If these rules are not well aligned, tax disadvantages may arise, and it may be difficult to discern whether the disadvantage arises from discrimination or disparity. The conceptual advantage of ICT is that it removes from consideration the laws of all member states other than the defendant member state. Thus, the defendant member state's laws would be applied in both a source and residence capacity. If the disadvantage remains, the defendant state's rules are discriminatory.

"FALSE DISCRIMINATION"

Between its first case in 1983 and the end of 2005, the ECJ decided just fewer than fifty income tax discrimination cases.[147] To be successful, any new theory for analyzing EC tax discrimination cases must replicate the results of CIST in the cases where the ECJ reached the correct decision. However, the theory should improve the results in cases where the ECJ erred. In *Biehl* and *Bachmann*, CIST and ICT led to the same result: a finding of tax discrimination.[148] Although the two tests should always lead to the same conclusion, I will show that ICT is more likely to facilitate accurate conclusions than CIST. For this reason, ICT should be the preferred standard when assessing tax discrimination cases.

[146] At least one European jurist regards this line of analysis relevant. When considering whether the ECJ erred in one of its rulings, Peter Wattel, an Advocate General for the Netherlands Supreme Court, reasoned that "the essence of the problem here is not the result of a disparity. . . . Even if the tax systems were fully harmonized (no disparities), the tax disadvantage would continue to exist." Wattel, *supra* note 2, at 219. Wattel ultimately concluded that the Court should have found discrimination because the disadvantage was "not caused by lack of harmonization, but by the fact that *national* systems *are internally structurally inconsistent*." *Id.* at 221 (emphasis added).

[147] *See* DG Tax List, *supra* note 102 (listing over one hundred cases, forty-nine of which included an income tax discrimination claim that was decided on the merits). *See* CIST Study, *supra* note 103.

[148] For a brief discussion of correctness the fiscal cohesion ruling in *Bachmann*, see *supra* text accompanying notes 142 to 145.

Errors by the Court of Justice in tax discrimination cases fall into two categories. The first kind of error is a false positive, where the ECJ mistakes perfectly legal variations in law across the member states for discrimination. These "false discrimination" errors unduly constrain member state tax sovereignty by prohibiting the use of tax measures that comply with EC law. The ECJ also finds false negatives. The ECJ commits the error of "false disparity" when it concludes that a tax disadvantage arises as the result of mere disparity in a case actually involving discrimination.[149] In such cases, the Court fails to protect individual rights of EU nationals. The importance of distinguishing tax discrimination from disparity justifies greater scrutiny of the ECJ's methods than they have received so far. Although there will always be disagreement about whether and in which cases the Court erred, certain personal income tax cases present themselves as likely candidates for judicial error, because they have received harsh criticism from tax experts. These cases include *De Groot, Manninen, Schempp,* and *D*.[150]

Personal Expenses: De Groot

De Groot v. Staatssecretaris van Financiën provides an example of the false discrimination error.[151] To simplify the facts, De Groot was a Dutch national and resident who earned part of his income in the Netherlands, and the rest from Germany.[152] The Netherlands exempted De Groot's foreign source income, but it only granted him a personal exemption in proportion to his Dutch-source income.[153] Suppose the Netherlands had a personal exemption of $5,000 and De

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[149] False discrimination is analogous to a Type I error in statistics, while false disparity is analogous to a Type II error.

[150] *See* citations *supra* note 21.

[151] Case C-385/00, De Groot v. Staatssecretaris van Financiën, 2002 E.C.R. I-11819. The ECJ's ruling in De Groot has been highly criticized. *See, e.g.,* Wattel, *supra* note 2; See Nils Mattsson, *Does the European Court of Justice Understand the Policy Behind Tax Benefits Based on Personal and Family Circumstances?* 43/6 EUR. TAX'N 186, 193-4 (2003) (arguing that the ruling "does not makes sense" and calling the Court's jurisprudence on personal expenses a "dead end").

[152] *De Groot* ¶¶ 27-29. In fact, De Groot also earned income from two other host countries: the United Kingdom and France. All three host countries taxed De Groot on the income he earned within their borders under the source principle of taxation, as limited by their tax treaties with the Netherlands. *See id.* ¶¶ 7-9, 18.

[153] *Id.* ¶ 18. *De Groot* also concerned personal expenses, but that part of the ruling was correctly decided under ICT. The formula used by the Netherlands to determine a resident taxpayer's proportion of the personal allowance was to multiply the full allowance by the following "proportionality factor:" $\frac{foreign\_gross\_income}{total\_gross\_income}$, which would reduce the tax benefit. *See* Wattel, *supra* note 2, at 211. The personal exemption is also referred to as the "tax-free amount" or the "zero bracket" of a progressive tax system, and it refers to a standard dollar amount of income that each taxpayer is permitted receive free of income tax. Two competing theories justify the exemption. One view is that the exemption is simply the lowest part of the tax rate structure. The other is that the exemption is "a

Groot had $100,000 in world-wide income. If only 40% of De Groot's income came from Dutch sources, he would only be taxable in the Netherlands on $40,000. Against that $40,000, the Netherlands would only allow 40% of the personal allowance, or $2,000. Because Germany did not allow non-resident taxpayers a portion of the personal allowance, De Groot did not receive any more than the $2,000 personal allowance the Netherlands gave him. De Groot argued that the tax detriment stemming from the Dutch proportionality method constrained his freedom to work in other member states.

The ECJ agreed. It compared De Groot with a Dutch taxpayer who earned all his income in the Netherlands and was therefore entitled to the full personal exemption.[154] The Court held that reduction in tax benefits in cases of cross-border work tended to discourage such activity, and therefore violated the freedom of movement workers.[155]

Applying the ICT would produce different results, which could explain why many feel that the Court erred in *De Groot.*[156] While it was true that under Dutch law, a resident taxpayer was only entitled to part of the personal allowance proportional to his Dutch-taxable income, *non-residents* were also entitled to the personal allowance in the Netherlands.[157] Applying the harmony constraint, suppose that every member state adopted the same tax rules as the Netherlands—suppose all states granted personal allowances to both resident and non-resident taxpayers in proportion to their income in the state. In that case, Germany would also grant De Groot part of the personal allowance in proportion to the income he earned there, so that in total, he would receive a full personal allowance.[158] The fact that the disadvantage would disappear if

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mechanism to exempt a subsistence level of income from taxation." MICHAEL J. GRAETZ & DEBORAH H. SCHENK, FEDERAL INCOME TAXATION PRINCIPLES AND POLICIES (2005).

[154] *De Groot*, ¶ 83.

[155] *Id.* ¶ 84.

[156] *See* citations *supra*, note 151.

[157] *See* Wattel, *supra* note 2, at 215. Notice that to be internally consistent, the Netherlands only had to grant non-resident taxpayers a pro rata share of the personal allowance. In fact, the Netherlands granted the *full* allowance to non-residents, which went beyond the minimum required by EC law. The fundamental freedoms do not prevent states from treating non-residents better than residents, they simply may not treat them worse. Preferential treatment for non-residents is addressed under the rubric of harmful tax competition. *See* discussion *supra* Part I.B.

[158] There is great variation in the amount of the personal exemption among the member states, but ICT assumes that all states would adopt the Dutch tax-free amount for purposes of determining whether there is discrimination. In reality, if each member state adopted the proportionality method with respect to its own personal exemption, a taxpayer with cross-border income might receive a greater or smaller personal exemption in a cross-border context than she would in a purely domestic context—the outcome would depend on whether the host states provided a greater or lesser personal exemption than her home state. However, as the application of ICT to the Dutch rules demonstrates, any difference would be the result of a disparity, not discrimination.

Dutch tax rules were adopted by all the member states highlights that the disadvantage was not created by Dutch law alone, but rather the interaction of Dutch and German rules.

The direction of the disparity in *De Groot* happened to be adverse: De Groot lost some of his Dutch personal allowance, and that loss was not compensated by advantages in Germany. The disparity between Dutch and German law created a distortion that discouraged Dutch residents from working in Germany.[159] However, when a German resident earned income from the Netherlands, she would benefit from the disparity because she would be entitled to a proportional share of the personal allowance in the Netherlands *and* the full personal allowance reserved by Germany to its tax residents. In the second case, the disparity between Dutch and German law creates a distortion that favors cross-border work.

A simple example will show that, in addition helping to identify disparities, ICT also aids in the attempt to identify discrimination. Suppose that under German law, the personal exemption was limited exclusively to tax residents. Under the harmony constraint, the other twenty-seven member states would have the same rule. Now imagine that De Groot earned 50% of his income from Germany and 50% from France. Under the universalized German rule, De Groot would receive no personal exemption anywhere, since he has insufficient taxable income in his home state of the Netherlands to use the Dutch exemption. In contrast, taxpayers with solely domestic income would receive the exemption.[160] Persistence of the disadvantage under the harmony constraint shows that the disadvantage stems not from disparity, but from discrimination. Thus the Court's error in *De Groot* is compound: the Court held that the Netherlands' innocent law was discriminatory, and it failed to recognize that the disadvantage in De Groot's case may indeed have been due to discrimination by Germany! Put simply, the ECJ failed to notice that De Groot sue the wrong member state.[161]

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[159] In *De Groot*, the Netherlands had an exceptional rule—most states allowed residents the full allowance and denied non-residents even a pro rata allowance. For discussion of the status of outlier rules as "undue burdens" or "restrictions," see *infra* Part V.D.

[160] In light of the importance the Court of Justice has placed on the need to grant full relief *somewhere* for an EU national's personal expenses, the Court would likely require both Germany and France to take a fraction of the personal expenses into account, the very legislative solution suggested by the Netherlands in *De Groot*. Case C-385/00, De Groot v. Staatssecretaris van Financiën, 2002 E.C.R. I-11819, ¶ 59.

[161] The German rule complied with the *Schumacker* judgment, which requires non-resident states to confer personal tax relief only when the non-resident earns "all or almost all" of his income in the host state. *See De Groot* at ¶¶ 54, 89; Case C-279/93, Finanzamt Köln-Altstadt v. Schumacker, 1995 E.C.R. I-225. Many consider the *Schumacker* rule an insufficient guard against discrimination, since it does not guarantee that personal expenses will be accounted for somewhere. One commentator noted that "just below the Schumacker threshold unspeakable fiscal grief persists." Wattel, *supra* note 2, at 212. The great irony of the *Schumacker* line of cases is that it led to the

The problem in *De Groot* was not that the Court failed to consider the possibility that the disadvantage was due to disparity. The Netherlands government specifically argued that the tax disadvantage suffered by De Groot was the result of "differences between the tax systems of the Member States, the existence of which is not… contrary to Community law."[162] But the application by the Court of CIST led it to erroneously conclude that "the disadvantage suffered by Mr de Groot is attributable neither to the disparities between the tax systems of the member states of residence and employment nor to the tax systems of the various States in which Mr de Groot was employed."[163]

Peril Averted

The ECJ committed the error of false discrimination in *De Groot* because it failed to examine the personal exemption with respect to the totality of the Dutch international tax system. Two countries claim the right to tax cross-border income: the "source" state and the "residence" state. The source or host state is the country where the income is earned. It claims a right to tax because it provided certain benefits that enabled the taxpayer to earn income within its borders, including natural resources, infrastructure, labor and capital markets, and so on.[164] The source state's jurisdiction to tax is limited by the benefits theory to income earned within its territory. The taxpayer's residence or home state, in contrast, generally asserts an unlimited right to tax its resident's profits wherever earned. The resident state's broader claim to tax stems from protections and privileges it extends to its residents at home and abroad, as well as any benefits, such as education, that enhanced the cross-border actor's ability to earn income abroad.[165] Simultaneous assertion of limited jurisdiction to tax by the source state and unlimited jurisdiction to tax by the residence state may result in double juridical taxation, which is avoided by

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wide-spread adoption of the discriminatory 90% threshold for personal expenses. *See* Case C-391/97, Gschwind v. Finanzamt Aachen-Außenstadt, 1997 E.C.R. I-5451 (implicitly approving the 90% threshhold).

[162] *De Groot* ¶ 57 (citing Case C-336/96, Gilly v. Directeur des Services Fiscaux du Bas-Rhin, 1996 E.C.R. I-2793).

[163] *Id.* ¶ 85.

[164] *See* Musgrave, *supra* note 37, at 1336-7 (2001). *See also* Reuven S. Avi-Yonah, *lobalization, Tax Competition, and the Fiscal Crisis of the Welfare State*, 113 HARV. L. REV. 1573 (2000).

[165] *See* Musgrave, *supra* note 37, at 1341-1342 (2001). *See* also Michael J. Graetz & Michael M. O'Hear, *The "Original Intent" of U.S. International Taxation*, 46 DUKE L. J. 1021, 1033-1041 (1997).

unilateral adoption of mitigation strategies by the residence state, or conclusion of bilateral double tax conventions between the source and residence state.[166]

Every country exercises tax jurisdiction in both a source and a residence capacity, since every country has both residents who invest or work outside its borders, and non-residents who invest or work within its borders. To judge whether an EU member state's system of taxation of cross-border commerce is discriminatory, it is necessary to examine both its source and its residence rules, a fact that has long gone unrecognized by the ECJ.[167] ICT provides an elegantly simple way to consider both the source and residence rules of the defendant member state. The harmony constraint imposes the defendant state's source *and* its residence rules on the same taxpayer. In *De Groot*, the taxpayer complained about the application Dutch residence rules. He argued that Dutch residence tax rules limiting his personal exemption, put him at a disadvantage in light of German source tax rules, which denied him the exemption entirely. However, under the harmony constraint, the Court considers what would happen if De Groot were subject to Dutch residence tax rules and *Dutch* source tax rules (now hypothetically applied by Germany). By applying Dutch source and residence rules, the distraction of Germany's disparate source rules is eliminated from the inquiry, and the Court can isolate any problems with the Dutch rules without worrying about noise from other tax systems. The harmony constraint eliminates all disparities, enabling the Court to identify lurking discrimination, without fear that the alleged tax disadvantage stems from disparities.

By deeming the particular tax laws of the other member state irrelevant to the question of whether the defendant state has discriminated, ICT helps the Court to follow its own admonition that discrimination by one state cannot be justified by the presence of offsetting advantages available to the taxpayer in another member state.[168] Indeed, one of the principle advantages of EC law is that EU nationals may arrange their affairs to take advantage of a jurisdiction's

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[166] The United States unilaterally avoids double tax by granting its residents a credit for foreign tax paid, which can be used to offset the U.S. tax on foreign-source income. I.R.C. §§ 901-908, 960. *See* Paul R. McDaniel, et al., INTRODUCTION TO UNITED STATES INTERNATIONAL TAXATION, 87-111 (2005). The United States has also entered into scores of bilateral double tax treaties based on the U.S. Model Treaty. *See U.S. Model Income Tax Convention,* Nov. 15, 2006, 1 TAX TREATIES (CCH) ¶ 209.

[167] Consideration of both source and residence rules is usually raised in the justification phase of ECJ rulings under the heading "fiscal coherence," but consideration of these issues should come earlier as part of the determination of whether there has been discrimination to avoid errors of false discrimination.

[168] Case C-294/97, Eurowings Luftverkehrs AG v. Finanzamt Dortmund-Unna, 1999 E.C.R. I-7447, ¶¶ 43-44 (tax advantages available in the taxpayer's state of establishment "cannot be used by another Member State to justify less favorable treatment").

favorable taxes and regulations.[169] If member states assessed compensatory taxes meant to offset the advantages the taxpayer received in other member states, the fundamental freedoms would have little meaning. Recognition that the determination of whether there is discrimination must be done in a single-country context is especially important as the cases of the ECJ become more complex. Taxpayers have already picked the low-hanging fruit in their challenges of member state law. Recent cases have become more complex as taxpayers challenge more subtle tax discriminations, and the ECJ needs a reliable standard for analyzing complex factual and legal circumstances. But recently, the Court has examined how the defendant state's law interacts with the law of other member states as part of the determination of whether there is discrimination.[170] While it is appropriate for the Court to consider whether the defendant state has, for example, shifted its obligation to grant a credit to another member state via a bilateral treaty, such considerations should be limited to the justification phase of the case.[171]

Cross-Border Dividends: Manninen

Another major source of controversy in the EC tax area concerns the taxation of cross-border dividends.[172] Cross-border dividends are dividends paid by a company resident in one country to a shareholder resident in a different country. The cross-border dividend is called an "outbound" dividend from the perspective of the company's state and an "inbound" dividend from the perspective of the shareholder's state. Cross-border dividends implicate both economic and juridical double taxation.

Economic double taxation occurs when the same item of income is taxed twice (often by the same country) in the hands of two different taxpayers. The classic example is the taxation of

[169] Case C-212/97, Centros, 1999 E.C.R. I-1459 (holding that Denmark could not refuse to register a branch of a company established in the United Kingdom, even if the company incorporated in the United Kingdom rather than Denmark to avoid the application of Danish capitalization rules and carried on no British activities).

[170] *See, e.g.,* C-446/03, Marks & Spencer plc v. Halsey, 2006 E.C.R. I-10,837 (holding that the obligation of the parent company's state to take into consideration losses of foreign subsidiaries depends on whether those losses may be taken in the subsidiary's state).

[171] Case C-385/00, De Groot v. Staatssecretaris van Financiën, 2002 E.C.R. I-11819, ¶ 100.

[172] *See, e.g.,* Dennis Weber, *supra* note 2, at 597-598 (2006) (arguing that the ECJ failed to respect member state tax sovereignty when it held in *Manninen* that imputation credits could not be denied on inbound dividends); Joachim Englisch, *Fiscal Cohesion in the Taxation of Cross-Border Dividends (Part Two)*, 44/8 EUR. TAX'N 355, 358-361 (2004) (arguing prior to *Manninen* that denial of imputation credits on inbound dividends was justified); Graetz & Warren, *supra* note 2, at 1208-1212 (lamenting the demise of imputation systems via judicial rather than legislative action).

corporate profits. A country may tax a corporation on its profits and the shareholder on receipt of dividends. The same economic income (corporate profits) is taxed twice: once to the corporation and a second time to the shareholder. For many years, the United States operated this kind of "classical" system, in which economic double taxation of corporate profits was unrelieved.[173] Since 2003, the United States has operated a "split-rate" system, under which the full measure of corporate tax is assessed, but a reduced tax rate applies to the shareholder.[174] The reduced shareholder rate partially mitigates economic double taxation. A country could also relieve double corporate tax by exempting either the corporation or the shareholder from tax.[175] In Europe, it was common to mitigate double corporate taxation through imputation credits.[176] Under an imputation system, tax is assessed at both the corporate and shareholder levels, but the shareholder receives a credit for the tax paid by the corporation.[177] The amount of the credit determines the extent of the double tax relief.

In contrast with economic double taxation, juridical double taxation occurs when the same item of income is taxed to the same taxpayer by two different jurisdictions, one usually acting in a source capacity, and the other in a residence capacity. Among the EU countries, double taxation is relieved on direct cross-border direct investments through the Parent-Subsidiary Directive and on other investments by double tax treaties.[178] These treaties divide the taxing rights between the source and residence country and provide for relief of any resulting double taxation.[179]

Cross-border dividends may be subject to both economic and juridical double taxation. Economic double tax results when the company's state taxes the corporation on its profits and the shareholder on the outbound dividend. International double taxation results if the shareholder's state taxes the inbound dividend. The same corporate profit would be taxed three times by two different jurisdictions: once at the corporate level and twice at the shareholder

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[173] *See* I.R.C. §§ 11, 61.

[174] *See* I.R.C. § 1(h)(11) (dividends taxed as capital gains).

[175] *See generally* ALVIN C. WARREN, JR., AM. LAW INST., INTEGRATION OF THE INDIVIDUAL AND CORPORATE INCOME TAXES, REPORTER'S STUDY OF CORPORATE TAX INTEGRATION (1993) (evaluating reasons for integration and methods to achieve it).

[176] Graetz & Warren, *supra* note 2, at 1208.

[177] U.S. DEP'T OF THE TREASURY, INTEGRATION OF THE INDIVIDUAL AND CORPORATE TAX SYSTEMS: TAXING BUSINESS INCOME ONCE 95 (1992) [hereinafter Treasury Report].

[178] Council Directive 90/435, 1990 O.J. (L 225) 6, as amended by Council Directive 2003/123, 2004 O.J. (L 7) 41 (eliminating double juridical taxation on dividends paid from a subsidiary in one member state to a 10% or greater corporate owner resident in another member state).

[179] *See* OECD, *Model Tax Convention on Income and Capital*, Jan. 28, 2003, 1 TAX TREATIES (CCH) ¶ 200.

level. As the next case shows, the intersection of these taxing rights makes applying the CIST particularly difficult.

Manninen involved a Finnish shareholder of a Swedish company.[180] Finland relieved double economic tax on corporate profits by granting resident shareholders an imputation credit for the taxes paid by resident companies. However, in the case of inbound dividends, Finland assessed the shareholder tax, but did not grant the imputation credit. [181] Finland argued that limitation of the imputation credit to shareholders of domestic companies was sensible, since only domestic companies paid corporate tax in Finland.[182] Granting resident shareholders imputation credits on inbound dividends would result in no Finnish tax being assessed at all, since Finland had no opportunity to collect corporate tax from the foreign company. Finland argued that since it only imposed economic double tax on domestic dividends, it should only have to relieve economic double tax on domestic dividends.[183]

The Court of Justice rejected this argument. Like Finland, the ECJ compared Finnish shareholders of domestic companies with Finnish shareholders of foreign companies, but rather than compare them with respect to the imposition of economic double tax *by Finland*, the ECJ compared them with respect to the imposition of economic double tax *by the combination of Finland and the company state.* This required the ECJ to examine the actual tax situation in Sweden, the company's state of residence. Since Sweden assessed corporate tax, both Finnish and Swedish dividends would be subject to economic double tax in the absence of an imputation credit.[184] Therefore, both inbound and domestic dividends were subject to economic double tax, making Finnish recipients of inbound dividends similarly situated to recipients of domestic dividends. It made no difference to the Court that in the case of inbound dividends, the first level of tax was assessed by another country. The ECJ held that the freedom of capital movement dictated that imputation credits must be granted to both, although the Court allowed that if the corporate tax paid in the foreign country were lower than the Swedish corporate tax, the imputation credit could be reduced.[185]

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[180] Case C-319/02, *In re* Manninen, 2004 E.C.R. I-7477, ¶¶ 12-15

[181] *Id.* ¶30. Because Finland was the shareholder's residence state, the cross-border dividends at issue were "inbound" dividends.

[182] *Id.* ¶ 30.

[183] *Id.* ¶ 30.

[184] *Id.* ¶ 35.

[185] *Id.* ¶¶ 36, 49-54. Finland and the United Kingdom objected that "it is impossible in practice to determine exactly the amount of [corporate] tax… which has affected dividends paid by a company established in another

The outcome of the case was controversial because many countries that operated imputation credit systems did not grant imputation credits on cross-border dividends.[186] One reason for this is that countries prefer to use the credit as a bargaining chip in tax treaty negotiations.[187] Automatic extension of imputation credits to foreign shareholders on outbound dividends or to resident shareholders for inbound dividends reduces a country's ability to secure reciprocal obligations in tax treaty negotiations.

Despite the controversy, the internal consistency test helps to show that *Manninen* was correctly decided. Suppose every member state enacted Finland's rule: shareholders of domestic companies receive imputation credits, but shareholders of foreign companies do not. In that case, across the entire EU, economic double taxation would always be relieved on domestic dividends, but never on cross-border dividends. The persistence of the burden on cross-border investment in the face of harmonization of tax rules highlights that burden was caused by Finnish discrimination, not disparities between Finnish and Swedish law.

There are several reasons why *Manninen* is easier to analyze under ICT than CIST. First, ICT does not require the ECJ to delve into Finland's public policy reasons for introducing the imputation credits. Finland argued that its goal in granting imputation credits was to relieve the double tax *imposed by Finland* on corporate profits, but the ECJ held that Finland's goal was to relieve corporate double tax, without respect to which jurisdiction collected the corporate level tax. The Court said:

> The objective pursued by the Finnish tax legislation, which is to eliminate the double taxation of profits distributed in the form of dividends, may be achieved by also granting the tax credit in favour of profits distributed in that way by Swedish companies to persons fully taxable in Finland.[188]

By focusing on the burden placed on intra-Community commerce, rather than the comparison between the complaining taxpayer and an internal taxpayer, the Court can avoid specific inquiries into the purposes of the legislature.

Member State." *Id.* ¶ 50. The ECJ responded that "difficulties in determining the tax actually paid cannot, in any event, justify an obstacle to the free movement of capital." *Id.* ¶ 54.

[186] Treasury Report, *supra* note 177, at 103. *See also* Hugh Ault, *Corporate Integration, Tax Treaties and the Division of the International Tax Base: Principles and Practices*, 47 TAX L. REV. 565, 585-6 (1992).

[187] Treasury Report, *supra* note 177, at 16. *See also* C-374/04, Test Claimants v. Comm'rs of Inland Revenue, http://curia.europa.eu/en/content/juris/index.htm (search for "Case C-372/04") (the United Kingdom negotiated the extension of imputation credits for outbound dividends via tax treaty to some member states, but not others).

[188] *Manninen*, ¶ 48.

Second, ICT allows the discrimination determination to be made without the need to look at the actual tax situation in Sweden. No matter how Sweden treats its corporations and shareholders, ICT shows that Finland's tax rules are internally inconsistent—they discriminate against cross-border dividends. This does not mean that a member state could not take the level of corporate tax in the other state into account when granting its credit—it would just have to do so in a way that was internally consistent.[189] But a member state that relieves double tax on domestic dividends cannot refuse to extend that benefit in appropriate situations to inbound dividends.

Erosion of Member State Sovereignty

In *De Groot*, Belgium intervened to argue that it would be unduly burdensome to impose upon the residence state the obligation to account for all of the personal expenses of residents, even though it taxed only the fraction of their income arising in the residence state. After all, the residence state already assumes the burden to provide "the greatest part of the public services provided to the taxpayer."[190] Belgium also argued that residents earning only domestic income and residents earning foreign source income were not similarly situated for tax purposes, since only the latter receive the benefit of salary splitting.[191] Finally, both Belgium and the Netherlands argued that the tax-free allowance is not related to income earned in any specific country, and therefore the burden of allowing it as an offset should be shared among the states in which the taxpayer earns income.[192] Whether or not one agrees with the equity arguments made by Belgium and the Netherlands, the Netherlands should be able to employ the method it prefers, as long as that method is EC law compliant.

When the ECJ strikes down Member State tax provisions in error, it needlessly narrows the tax policy options open to the Member States. In *De Groot*, the ECJ established a priority rule for which country should account for the personal exemption. It removed the decision from the

[189] The 1992 Ruding Committee Report recommended that the shareholder member state be required to grant the lesser of the company state's degree of tax relief, or its own. *See* Ault, *supra* note 186, at 591-2.

[190] Case C-385/00, De Groot v. Staatssecretaris van Financiën, 2002 E.C.R. I-11819, ¶ 64.

[191] *Id.* ¶¶ 61-65. For an example showing the tax benefits of salary splitting, see *supra* note 114.

[192] *Id.* ¶¶ 61-65. *Compare* Lunding v. New York Tax Appeals Tribunal, 522 U.S. 287 (1998) (concluding in a case considering the deductibility of alimony payments by a non-resident taxpayer under the Privileges and Immunities Clause that a U.S. state could not "disallow nonresident taxpayers every manner of non-business deduction on the assumption that such amounts are inevitably allocable to the State in which the taxpayer resides").

control of the states, and by extension, their voters. Judicially imposed priority rules are appealing; they prevent situations in which mismatches between the (non-discriminatory) laws of two states would result in a double benefit or double detriment. The priority rule in *De Groot*, for example, prevents situations in which a personal exemption is granted by both the residence state and the host state, or by neither.[193] Notwithstanding the apparent clarity engendered by judicial priority-setting, there are a number of reasons that the ECJ may not be the best institution to establish tax priorities.[194] When the Court reaches beyond its charter to interpret EC law and declares not just that a member state's law is incompatible with EC law, but also what the member state's law *should have been*, it substitutes its own judgment for that of the democratically elected legislature of the member state.[195] Compared with national legislatures, the Court of Justice may be poorly equipped to decide tax policy issues because it lacks tax expertise. Additionally, the Court's scope is narrow: it only sees cases that happen to be referred to it, and those cases may be unrepresentative.[196] Additionally, tax policy measures, particularly when they touch on social welfare policies enacted through national tax codes, reflect the national character and democratic will of the population of each state. The Court strains legitimacy when, rather than simply giving a negative interpretation of EC law, it promulgates a positive tax priority rule.[197]

Finally, when the Court eliminates *non-discriminatory* tax laws, it may inadvertently invalidate rules that are particularly well-suited to address tax problems in an increasingly integrated market. This was the case in *De Groot.* Apportionment arguably serves the spirit of the common market better than the residence-state-take-all method devised by the ECJ.[198]

[193] The ECJ has consistently expressed a preference for personal and other tax relief to be granted exactly once in cross-borders situations. It opposes both "double-dipping" and cases in which no or incomplete relief is granted. *See, e.g.,* C-446/03, Marks & Spencer plc v. Halsey, 2006 E.C.R. I-10,837, ¶ 47.

[194] MADURO, *supra* note 44, at 59.

[195] Baker, *supra* note 3, at 454 ("the role of the ECJ is not to tell national governments what their tax system should have looked like."); Case C-374/04, Test Claimants v. Comm'rs of Inland Revenue (Feb. 23, 2006) (opinion of Advocate General Geelhoed), ¶ 64 http://curia.europa.eu/en/content/juris/index.htm (search for "Case C-372/04") ("Community law does not contain any basis for allocating such jurisdiction and priority.").

[196] For example, in *De Groot*, the taxpayer arguably sued the wrong member state, but the ECJ could only impose an obligation on the state involved in the case. *See supra* text accompanying note 161.

[197] *But see* MADURO, *supra* note 44, at 70-78. Maduro suggests that the majority view in each state may be a minority view from the perspective of the whole EU. Since the Court protects the EU-wide majority, far from facing an anti-majoritarian difficulty, the Court of Justice is a force for majoritarianism.

[198] "Given the differences among the tax systems, this approach represents the highest possible degree of equal treatment of a non-resident taxpayer with resident taxpayers…" Kees van Raad, *Fractional Taxation of Multi-State Income of EU Resident Individuals—A Proposal in* LIBER AMICORUM SVEN-OLOF LODIN 211, 221 (Krister Anderson ed., 1999).

Apportionment de-emphasizes national borders and tax residence, whereas the rule expounded in *De Groot* elevates state of residence above economic substance. According to Professor Peter Wattel, the Advocate General for the Netherlands Supreme Court in *De Groot*, pro rata allocation of personal expenses among the states in which the taxpayer earns income is an "elegant" solution to the cross-border problem because it "does not interfere … with the fiscal sovereignty of the member states."[199]

"FALSE DISPARITY"

In contrast with cases of false discrimination, which infringe the sovereignty of EU member states, cases of false disparity implicate the personal rights of EU nationals. False disparity occurs when a member state discriminates in violation of the EC Treaty, but the ECJ fails to recognize the discrimination, instead attributing the tax disadvantage to a disparity between two or more member states' laws. Rooting out cases of false disparity is crucial to protecting EU nationals against discrimination by the member states.

Cross-Border Alimony Payments: Schempp

Schempp v. Finanzamt München V demonstrates how CIST fails to distinguish between disparity and discrimination.[200] In that case, a German tax resident made alimony payments to his former spouse who resided in Austria. Under German law, alimony was includable to the recipient and deductible to the payer. However, if the recipient resided outside Germany, then to qualify for the deduction, the payer had to provide a certificate from the recipient's country showing that the alimony had been taxed to the recipient.[201] In contrast, no certification that a German resident recipient had been taxed on the alimony was required. In short, the payer could deduct alimony if it was paid to a German resident whether or not the German resident was

[199] Wattel, *supra* note 2, at 214.
[200] Case C-403/03, Schempp v. Finanzamt München, 2005 E.C.R. I-06421.
[201] As a further condition, the ex-spouse had to reside in an EU Member State. *Id.* ¶ 5.

actually taxed on it, but could only deduct alimony paid to a foreign resident if the foreign resident was actually taxed on it.

Germany required proof of taxation of the foreign recipient's alimony because it wanted to ensure that the alimony income would be taxed at least once, but not more than once, between the former spouses. Allowing a deduction to the payer in a case in which the recipient was not taxed would not be appropriate because then alimony would be taxed neither to the payer nor the recipient.[202] Schempp could not provide the requisite proof that his ex-wife was taxed on the receipt of alimony, since she resided in Austria, and Austria does not tax alimony income.[203] Had his ex-wife resided in Germany, Schempp would have received a deduction, but because she resided in Austria, he did not. Schempp argued that Germany discriminated on the basis of the residence of his ex-wife in violation of the freedom of movement of persons.[204]

The ECJ rejected Schempp's argument. In the Court's view, alimony paid to an Austrian resident was not comparable to alimony paid to a German resident because Austrian and German recipients were subject to different tax treatment.[205] Germany taxed alimony to the recipient, but Austria did not. Since the two situations were not similar, there was no discrimination, and the disadvantage suffered by Schempp was simply the result of disparity between Austrian and German tax rules.[206] The Court even pointed out that if Schempp's ex-wife resided in another member state, such as the Netherlands, that taxed support payments to the recipient, he would

[202] Germany's method made the recipient, not the payer, taxable on the alimony. Imposition a single tax on the former couple could have also been achieved by exempting the recipient, but disallowing the deduction to the payer, which would make the payer the taxable person.

[203] *Schempp* ¶ 9.

[204] The ECJ accepted Schempp's argument that the because his ex-wife's exercise of her Article 18 freedom of movement resulted in adverse tax consequences for him, he could avail himself of the protection of the EC Treaty. *Id.* ¶¶ 22-25.

[205] *Id.* ¶ 35. The U.S. Supreme Court considered the alimony issue from the perspective of the host state in Lunding v. New York Tax Appeals Tribunal, 522 U.S. 287 (1998). The question was whether New York had to allow a Connecticut resident to deduct part of his alimony payment proportional to his New York-taxable income. The Supreme Court held that the Privileges and Immunities Clause forbade New York from categorically denying the alimony deduction to all non-residents without a "substantial justification for the difference in treatment." *Lunding* at 298. The Court did not expressly address the effect of tax treatment by the residence member state, although in her dissent Justice Ginsburg forcefully argued that fact that the taxpayer and his ex-wife both resided in Connecticut, which at the time had no income tax, made an alimony deduction to the paying spouse inappropriate because it would result in a deduction for Lunding with no related inclusion for his former wife. *Id.* at 316-20 (Ginsburg, J., dissenting).

[206] According the Court, "it is apparent that the unfavourable treatment of which Mr Schempp complains in fact derives from the circumstance that the tax system applicable to maintenance payments in his former spouse's Member State of residence differs from that applied in his own Member State of residence." *Schempp* ¶ 32.

have received the deduction.[207] Since Schempp's disadvantage stemmed from disparity rather than discrimination, it did not violate the EC Treaty.

The Court took insufficient notice of the additional substantive requirements imposed on German alimony payers with non-resident former spouses. Had Schempp's ex-wife resided in Germany, the alimony would have been includable to her, but since her total income did not rise above Germany's tax-free allowance, she would not have paid any tax on the alimony. Thus, if both Schempp and his ex-wife lived in Germany, Schempp would get the deduction, notwithstanding that his wife would *in fact* pay no tax.[208] In a wholly domestic situation, the deduction was not conditional upon the receiving spouse actually paying tax on the alimony. Rather, all that was required for the deduction was that the recipient spouse reside in Germany. In contrast, payers with non-resident spouses were subject to a higher standard. In addition to showing that the alimony was includable as a matter of law in the former spouse's income, the payer also had to provide certification that the former spouse actually paid tax on the alimony. Thus, the Court was wrong when it suggested that if Schempp's ex-wife resided in the Netherlands, which taxes alimony, Schempp would get the deduction. The deduction would be further conditioned upon the Dutch personal exemption. If it were the same as Germany's, then Schempp's ex-wife would not be *actually taxed* on the alimony by the Netherlands, and Schempp would not get the deduction because he would not be able to provide proof of his ex-wife's tax.[209]

Again, ICT alleviates the burden to look at the actual tax situation in Austria, the Netherlands, or any other country other than the defendant state. Suppose that every member state enacted the same tax laws as Germany with regard to alimony and the tax-free allowance. In that case, Austria—now applying tax law identical to Germany's—would have included the ex-wife's alimony in her income. However, she would not have been taxed on the alimony because her income would not have exceeded the tax-free allowance. Germany would deny the deduction to Schempp because he would be unable to show that his ex-wife *actually* paid tax on the alimony in Austria. In contrast, if his ex-wife resided in Germany, Schempp would be entitled to the deduction, despite the fact that his ex-wife would not actually pay tax on it. The

[207] *Id*. ¶ 33.
[208] *Schempp*, ¶ 37.
[209] Schempp raised this question, but as the referring national court did not raise it, the Court did not address it. *Schempp* ¶ 38.

adoption by Germany of different rules regarding resident and non-resident alimony recipients would lead to harsher taxation in the case of non-resident recipients *even if substantive tax rules were perfectly harmonized.* As a result, it must be concluded that Germany's different conditions for deduction of alimony paid to non-residents was discrimination, not disparity.

Notice, however, that under the internal consistency doctrine, Germany could preserve its law with a small modification. If Germany also required proof that a German resident recipient was taxable on the alimony, so that the requirement was neutral as regards resident and non-resident recipients, then Germany's rule would survive the internal consistency test. Germany's policy behind requiring proof that the non-resident recipient was taxed was to ensure that the alimony would be taxed to at least one member of the former couple—the payer or the recipient. This policy would be preserved if the rule regarding proof were consistent for resident and non-resident recipients. Thus, it is important to note that the application of the internal consistency doctrine does not preclude Germany from conditioning tax benefits upon the relevant tax situation in fellow member states, but benefits must be conferred without discrimination.

Most-Favored Nation Obligation: The D Case

No discussion of EC tax discrimination would be complete if it did not address the most-favored nation (MFN) issue. Probably the touchiest subject in EC tax law, and a subject of tremendous scholarly attention, is the question of whether countries must offer EU nationals the benefit of their most favorable tax treaty with another country.[210] There are 276 bilateral tax treaties in place between the EU member states, and no two are identical.[211] Although the treaties are substantially similar due to the OECD Model process, important differences remain.[212]

[210] 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, 455 (2005); Georg W. Kofler & Clemens P. Schindler, *"Dancing With Mr D": The ECJ's Denial of Most-Favoured-Nation Treatment in the "D" Case,* 45 EUR. TAX'N 530, 539 (2005). Both of these articles contain extensive literature references. For a detailed history and analysis of the arguments on both sides of the MFN controversy, see van Thiel, *supra* note 2, at 349-371..

[211] *See* European Commission, *EC Law and Tax Treaties* (Working Document), presented at a workshop of experts in Brussels on July 5, 2005 (detailing in appendix B the intra-EU network of 276 bilateral tax treaties), available at http://europa.eu.int/comm/taxation_customs/resources/documents/taxation/personal_tax/double_tax_conventions/ECLawTaxTreaties_annexB_en.pdf.

[212] *See* Mason, *supra* note 2, at 121-123.

The ECJ held that EC law does not impose a most-favored nation obligation, at least with regard to tax treaties, in *D. v. Inspecteur van de Belastingdienst*.[213] Mr. D was subject to wealth tax in the Netherlands, where he held 10% of his property. The remainder of his property was located in Germany, where D resided. Dutch residents were entitled to an exemption from the wealth tax for a certain dollar amount of property, but D was denied the exemption because he was not a resident. Because Germany had no wealth tax, it granted Mr. D no wealth tax exemption. As a result, unless Mr. D received the wealth tax exemption in the Netherlands, he would receive no exemption anywhere. Mr. D argued that limitation of the exemption to Dutch residents violated the freedom of capital movement.[214]

The Court disagreed, holding that Mr. D was not in a comparable situation to a Dutch-resident taxpayer, since the Dutch resident would be taxable in the Netherlands on all of his world-wide wealth, whereas Mr. D was only taxable on his wealth situated in the Netherlands.[215] Since Mr. D and the hypothetical Dutch resident were subject to tax upon different tax bases, they were not similarly situated for wealth tax purposes, and the Netherlands did not have to treat them the same. ICT confirms the Court's analysis: if every member state enacted the Dutch wealth tax regime, then all EU residents would be subject to tax on their world-wide wealth in their state of residence and entitled to an exemption only in that state. An EU national would also be taxable by the country in which his or her wealth was situated, but would not be entitled to an exemption there.[216] Thus, every EU national would be entitled to exactly one wealth tax exemption, which would be granted by his or her home state. The fact that Mr. D received no wealth tax exemption was a result of a disparity between Dutch and German law.

Mr. D made another claim in his case, based on the double tax treaty between the Netherlands and Belgium. Under that treaty, Belgian residents were entitled to the Dutch wealth tax exemption, even though (like German residents) they were only subject to tax in the

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[213] Case C-376/03, D. v. Inspecteur van de Belastingdienst, 2005 E.C.R. I-5821. *But see* Case C-307/97, Compagnie de Saint-Gobain, Zweigniederlassung Deutschland v. Finanzamt Aachen-Innenstadt, 1999 E.C.R. I-6161 (tax treaty benefits available to subsidiaries must also be extended to branches); Case C-466/98, Commission v. United Kingdom, 2002 E.C.R. I-9427; Case C-467/98 (open skies) (benefits of a bilateral air transportation agreement between Britain and the United States cannot be limited to airlines owned by U.S. and British nationals, but must be extended to all EU airlines).

[214] *D* ¶ 20.

[215] *D* ¶¶ 35-43.

[216] Notice that to be internally consistent, the country of residence would have to credit the tax levied by the country of situs of the property. Because the Court of Justice does not apply ICT, the facts of the *D* case do not indicate whether such a credit was provided by the Netherlands.

Netherlands on their wealth situated in the Netherlands, and Belgium offered no wealth tax exemption because it did not tax wealth.[217] Mr. D argued that denial of the exemption to German residents when it was extended to Belgian residents violated the freedom of capital movement.[218]

The ECJ rejected this argument as well, on the grounds that a German resident and a Belgian resident were not similarly-situated for Dutch wealth tax purposes.[219] In the Court's view, the differences between the German-Dutch tax treaty and the Belgian-Dutch tax treaty placed German and Belgian taxpayers in different situations for Dutch tax purposes. According to the Court, the fact that Germans were excluded from the benefits of the Belgian-Dutch tax treaty was

> an inherent consequence of bilateral double taxation conventions. It follows that a taxable person resident in Belgium is not in the same situation as a taxable person resident outside Belgium so far as concerns wealth tax on real property situated in the Netherlands.[220]

The Court suggested that two non-resident taxpayers subject to two different tax treaties will never be similarly situated for tax purposes, no matter how similar their actual tax situations. Thus, the difference in tax treatment by the Netherlands of D and a hypothetical Belgian resident was the result of disparities in Belgian, German, and Dutch law, not discrimination by the Netherlands.

When considering the most-favored-nation question in the *D* case, the Court of Justice applied CIST by comparing a taxpayer resident in the disfavored state to a taxpayer residing in the favored state. Thus, rather than comparing D to a Dutch taxpayer, the Court appropriately compared D to a hypothetical Belgian resident taxpayer. As a second step to the analysis, the Court would have compared the treatment of these two taxpayers under Dutch law. However, the ECJ did not reach the second stage of analysis in *D* because it held that no German taxpayer could ever be similarly situated to a Belgian taxpayer for Dutch tax purposes, as long as the Netherlands has different tax treaties with Germany and Belgium.[221]

How does this reasoning fare under ICT? If every country adopted the Dutch wealth tax regime, then every country would grant both its own residents and Belgian residents the wealth

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[217] *D* ¶ 44-45.

[218] *D* ¶¶ 44-47.

[219] *D* ¶ 59-63.

[220] *D* ¶ 61.

[221] *D* ¶¶ 59-63. *See* Michael Lang, *Direct Taxation: Is the ECJ Heading in a New Direction?* 46 EUR. TAX'N 421, 421 (2006) (including *D* and *Schempp* among "other recent cases in which the ECJ stopped its examination… by denying comparability… without providing further reasoning").

tax exemption, but deny the exemption to Germans. Thus, cross-border investments in property by German tax residents would be systematically disfavored as compared with investments by Belgian tax residents. Since EC law prohibits discrimination on the basis of nationality, and residence may serve as a proxy for nationality, such favoritism presumably violates EC law.

To make it clear that the ECJ's approach to the most-favored-nation question is inadequate, suppose that Belgium's tax laws were identical in every respect to Germany's. That is, suppose Belgium adopted by reference the tax laws of Germany as its own. Now suppose that Taxpayer G resides in Germany and Taxpayer B resides in Belgium. In every tax respect, G and B are identically situated: they have the same amount of net income, earned from the same sources, and they have the same amount of wealth. G owns 90% of his real property in Germany, which has no wealth tax, and 10% of his real property in the Netherlands, where it is subject to wealth tax with no exemption. B owns 90% of his real property in Belgium, which has no wealth tax, and 10% of his real property in the Netherlands, where it is subject to wealth tax, but only after application of the exemption under the Belgian-Dutch tax treaty.

Under the Court's reasoning, since G and B are covered by different tax treaties with the Netherlands, they would not be similarly-situated, even though we have constructed the hypothetical to put them in precisely the same tax situation. Critics of the *D* case argue that the Court gave the member states a back door method to discriminate—as long as the discrimination is achieved through a double tax treaty, it will not violate EC law.[222]

One immediate objection to this line of reasoning is that our counterfactual assumption—that Belgian law is identical to German law—may obscure significant differences in the tax laws of those countries that justify different terms in their double tax treaties with the Netherlands. The tax situations of two taxpayers residing in different member states may be comparable or incomparable, but in order to apply CIST correctly, the Court must make an actual determination as to their degree of comparability.[223] The Court inadequately protects EU taxpayers from nationality discrimination when it applies CIST to mean that any two taxpayers subject to different tax treaties are always incomparable.

[222] van Thiel, *supra* note 210, at 455; Kofler & Schindler, note 210, at 539.

[223] The Court's analysis of EC tax cases comprises four stages: (1) Has an EC right been exercised? (2) Is there a violation of EC law? (3) Can the violation of EC law be justified by reasons of public policy? (4) Is the restrictive provision proportional to the justifiable public policy goal? *See* MASON, PRIMER, *supra* note 7, at 38.

Infringement of EC Fundamental Freedoms

Many commentators think that the ECJ bowed to political pressure from the member states in the *D* case.[224] Member states strongly opposed the imposition of a most-favored-nation requirement as part of EC law.[225] While ICT can do nothing to remove political pressures from the Court of Justice, it can make the legal conclusion that there is discrimination more obvious and therefore more difficult to avoid through the application of the more easily manipulated CIST. By deeming German and Belgian taxpayers to be incomparable, the ECJ could avoid finding that the Netherlands discriminated against D. It is interesting also that *D* is a rare case in which the Court did not adopt the views of the Advocate General. The Advocate General urged the Court to find that D was similarly-situated to a Dutch resident taxpayer, and therefore entitled to the same wealth tax exemption as a Dutch resident.[226] The Advocate General's opinion was seen as a compromise: D would get his wealth tax exemption, but the Court of Justice could avoid ruling on the MFN issue.[227] The Court correctly declined to follow the Advocate General's reasoning, but his opinion highlights that both the pair chosen for comparison, as well as the attributes compared under the CIST, are subjective.

If Alec Stone Sweet is correct that "[i]in deciding, a constitutional court makes policy *and* constructs the constitution," then by deciding that tax treaty preferences cannot be discriminatory, the Court of Justice narrows the rights of EU nationals.[228] Thus, it is important

[224] van Thiel, *supra* note 210 at 456.

[225] The governments which have submitted observations and the Commission submit conversely that the different treatment of a person such as Mr D and a resident of Belgium is not discriminatory. They argue that a Member State party to a bilateral convention is not in any way required, by virtue of the Treaty, to extend to all Community residents the benefits which it grants to residents of the Contracting Member State. Those governments and the Commission refer to the danger which the extension of the benefits provided for by a bilateral convention to all Community residents would entail for the application of existing bilateral conventions and of those which the Member States might be prompted to conclude in the future, and to the legal uncertainty which that extension would cause.

Case C-376/03, D. v. Inspecteur van de Belastingdienst, 2005 E.C.R. I-5821, ¶ 48.

[226] *See* Case C-376/03, D. v. Inspecteur van de Belastingdienst, 2005 E.C.R. 5821 (Oct. 26, 2004) (opinion of Advocate General Ruiz-Jaraba Colomer).

[227] Axel Cordewener & Ekkehart Reimer, *The Future of Most-Favoured Nation Treatment in EC Law—Did the ECJ Pull the Emergency Brake without Real Need? Part II* 46 EUR. TAX'N 291, 294 (2006).

[228] ALEC STONE SWEET, GOVERNING WITH JUDGES: CONSTITUTIONAL POLITICS IN EUROPE 96 (2000). Stone Sweet notes that although the ECJ has elaborated "a charter of rights for the Community," the original purpose of the fundamental freedoms "was not so much to create rights claims for individuals, as to remove potential distortions within an emerging common market." *Id.* at 170-171.

to the maintenance of EU nationals' personal rights that the ECJ adopt a standard of review that does not obscure tax discrimination. Additionally, the anti-discrimination norm will only reinforce economic and political union to the extent that the Court recognizes and censures discrimination. Finally, when the Court fails to recognize discrimination, it allows the states to keep in place distortive taxes that reduce the social welfare of Europeans. In short, failure to identify discriminatory taxation puts distance between the EU and its goal to become "the most dynamic information-based economy in the world."[229]

LIMITATIONS OF ICT

Unavoidable Comparison

I have argued that adoption by the ECJ of the internal consistency test for its tax discrimination cases would help the Court avoid two kinds of errors: false positives (false discrimination) and false negatives (false disparity). ICT is superior to CIST because it simplifies the factual and legal circumstances under which the Court must compare the cross-border situation with an internal situation. Rather than trying to determine which elements of the defendant and other member states' laws may be relevant to the comparison, under ICT's harmony constraint, all states are assumed to have the same law as the defendant state.

But the harmony constraint does not eliminate the need for the Court to draw a comparison—claims of discrimination are comparative in nature, and the Court cannot completely avoid comparing the treatment of intra-Community commerce and the treatment of purely domestic commerce. However, by eliminating the distractions created by the diversity of tax laws in the various member states, the Court can focus exclusively on the tax laws of the challenged state. Thus the main advantage of ICT over CIST when making the comparison is that the factual situation is simpler under ICT, and we have seen how simplifying the factual situation by imposing the harmony constraint made the discrimination determination easier in the *Biehl*, *Bachmann*, *De Groot*, *Manninen*, *Schempp*, and *D* cases.

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[229] *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).

Fixing the Counterfactual Antecedents

ICT is also susceptible to criticism because it is hypothetical. The harmony constraint does not obtain in reality, so the Court is forced to engage in counterfactual reasoning.[230] How does the Court determine the scope of the counterfactual? Does imposition of the harmony constraint mean that only the challenged tax rule, defined as narrowly as possible, should be universalized to all the other states? Or does it mean something broader, for example that every member state should be assumed to have *all* the same tax laws as the challenged member state? What, precisely, does it mean to assume that all the other member states apply the challenged rule? What else about their tax systems would also have to change to make the counterfactual true? This problem of fixing the counterfactual antecedents could reintroduce some of the uncertainty seen in the comparability analysis under CIST.[231]

The U.S. experience shows that fixing the auxiliary antecedents has not posed a serious problem,[232] and while ICT involves hypothetical reasoning, so does CIST. Under CIST, the ECJ posits a stylized complainant and compares him to a stylized internal taxpayer. The comparison of the complaining taxpayer's situation to that of an internal taxpayer, endowed by the Court of Justice with attributes chosen according to no enunciated standards, has a mysterious (and hypothetical) quality. While we can argue about the scope of the harmony constraint, and commentators may disagree as to whether it was applied correctly in a particular case, at least it is a more transparent methodology than the one the Court presently uses.

Most Favored Nation

A significant short-coming of ICT is that it cannot easily be applied to most-favored-nation cases.[233] In such cases, a member state grants better treatment (usually in double tax treaties) to residents of one EU member state than to residents of another state. Thus, rather than preferring its own residents to non-residents, the member state prefers some non-residents to other non-residents. Because the criterion for granting the tax preference in these cases is nationality, or a

[230] *See* Hellerstein, *supra* note 96, at 143, 165.

[231] Philosophers have long contemplated the auxiliary counterfactual antecedent problem. *See* NELSON GOODMAN, FACT, FICTION AND FORECAST 16 (1979).

[232] *See* Hellerstein, *supra* note 96, at 143, 165-170 (citing the hypothetical nature of ICT as one of its disadvantages).

[233] *See supra* Part IV.B.

proxy for nationality such as tax residence, they raise nationality discrimination concerns. But a national rule that says, "residents of Greece will be taxed more favorably than residents of Italy" is not susceptible to universalization. How would we apply the harmony constraint in Greece? In Italy? One response to this criticism is to note that the fact that a member state's rule cannot be universalized is itself evidence that it is discriminatory. Although such discrimination may be justified for public policy reasons, it would be erroneous to conclude, as the ECJ has, that most-favored-nation cases never involve tax discrimination.

Market Restrictions

It bears repeating that this Article deals only with member state taxes that discriminate, not those that create market access restrictions. Market access restrictions are analogous to the U.S. conception of an "undue burden" on interstate commerce. Historically, the ECJ has decided almost all of its income tax cases on discrimination grounds, but recently, the Court has placed new emphasis on direct tax "restrictions."[234] There is some uncertainty about the applicability of restriction analysis to direct tax cases, and I offer no opinion on that question here.[235] However, to the extent that there is a difference between the two, ICT would not solve restriction cases.

To see why, recall the facts of *Moorman*.[236] In that case, the taxpayer challenged Iowa's use of single-factor sales as its apportionment method at a time when nearly all other states used a three factor formula. The U.S. Supreme Court held that the Iowa rule was non-discriminatory. Put in explicitly ICT terms, if every state adopted single-factor sales, there would be no double taxation. Thus, under ICT, the U.S. Supreme Court was correct to conclude that the Iowa rule was non-discriminatory. ICT is silent about whether non-discriminatory rules nevertheless unduly restrict cross-border flows. In *Moorman*, the Court could have considered, although it did not, whether the adoption by Iowa of a non-discriminatory apportionment formula that differed from all the other states' formulas was "one of those cases—few in number—where…

[234] *See, e.g.,* C-446/03, Marks & Spencer plc v. Halsey, 2006 E.C.R. I-10,837 (holding that the United Kingdom's refusal to offset British income with losses of foreign subsidiaries in cases where those foreign losses could not be taken in the subsidiary's country restricted the British parent's freedom of establishment); Case C-250/95, Futura Participations SA v. Administration des contributions, 1997 E.C.R. I-2471 (holding burden placed on non-residents to keep an extra copy of their books in the host state was restrictive).

[235] *See* sources cited *supra* note 69. *See also* Michel Aujean, *The Future of Non-Discrimination—Direct Taxation in Community Law in* COMPARATIVE FISCAL FEDERALISM 322, 324 (Reuven Avi-Yonah, James R. Hines, Jr. & Michael Lang eds., Kluwer 2007) (considering whether the Court will adopt restriction analysis more often in future direct tax cases).

[236] Moorman Manufacturing Co. v. Bair, 437 U.S. 267 (1978). *See* discussion *supra* Part II.A.

measures that are nondiscriminatory place an unconstitutional burden on interstate commerce."[237] Thus, if the ECJ plans to consider whether *non-discriminatory* taxes restrict intra-Community commerce, ICT will be of no assistance.

Reciprocal & Retaliatory Taxation

The last criticism of the ICT is that it is gameable by the member states. Suppose the Netherlands always granted residents a proportional personal exemption, but would only grant non-residents a proportional exemption if all other member states also granted non-residents proportional exemptions. By conditioning similar treatment for non-residents on the demand for EU-wide reciprocity, has the Netherlands satisfied ICT? The answer appears to be yes. When we universalize the Dutch rule under the harmony constraint, the condition for the Netherlands to grant exemptions to non-residents is fulfilled, so a non-resident would suffer no adverse treatment. However, under ordinary conditions, the reciprocity requirement would not be satisfied, and non-residents would be denied the exemption.

Before we conclude that we needn't worry about this rather obvious form of discrimination, consider the U.S. case *Western & Southern*.[238] California imposed a "retaliatory" tax on foreign insurance companies operating in-state, but only if the company's home state imposed a similar tax on California insurers doing business in that state.[239] The Supreme Court held that California's rule did not violate the Equal Protection Clause because California's "purpose in enacting the retaliatory tax, to promote interstate business of domestic insurers by deterring *other States* from enacting discriminatory or excessive taxes—was a legitimate one."[240] Perhaps the Court's holding in *Western & Southern* can be explained by the standard of review applied in the case. The Court did not analyze California's tax under the Commerce Clause because Congress consented to state regulation of insurance under the McCarran-Ferguson Act.[241] Thus, California's tax was only given rational basis review under the Equal Protection Clause. In

[237] Bibb v. Navajo Freight Lines, Inc., 359 U.S. 520, 528 (1959) (invalidating a non-discriminatory state mudguard regulation that differed from the mudguard regulation of forty-five other states).

[238] Western & Southern Life Ins. Co. v. State Board of Equalization of California, 451 U.S. 648 (1981).

[239] *Id.* at 650 (1981).

[240] Metropolitan Life Ins. Co. v. Ward, 470 U.S. 869, 876-877 (1985) (distinguishing California's tax in *Western & Southern* from a higher tax rate imposed by Alabama on premiums paid to out-of-state insurers) (emphasis in original).

[241] *Western & Southern* at 651 ("Congress removed all Commerce Clause limitations on the authority of the States to regulate and tax the business of insurance when it passed the McCarran-Ferguson Act.").

contrast, when the Supreme Court considered a discriminatory tax with an element of reciprocity under the Commerce Clause, it had no trouble striking it down.[242]

CONCLUSION

The role of the Court of Justice has been central to the integration of the European economy.[243] Without the ECJ, it is likely that discriminatory tax regimes would go unchecked in the European Union. However, the ECJ could benefit from the experience of the U.S. Supreme Court in dealing with state tax discrimination cases. Tax discrimination cases raise difficult federalism issues, and tax is not a subject matter loved by most judges. As a result, it is not surprising that the ECJ struggles with these cases as the U.S. Supreme Court has.[244] Nor is the U.S. Supreme Court a model to be generally emulated. The Supreme Court has referred to its own state tax discrimination jurisprudence as "a tangled underbrush."

Indeed, an apt criticism of the U.S. Supreme Court is that it does not apply internal consistency consistently.[245] Moreover, the U.S. Supreme Court usually applies the internal consistency test to business tax apportionment cases, not personal taxation cases.[246] Personal tax discrimination is usually considered by the Supreme Court under the Privileges and Immunities Clause, in which the Court adopts a method of analysis quite similar to CIST.[247] However, ICT need not be limited to apportionment cases. It can be a powerful analytical tool in substantive tax discrimination cases in the EU. First, there is no reason ICT cannot apply to cross-border

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[242] *See* New Energy Co. of Ind. v. Limbach, 486 U.S. 269 (1988) (striking down an Ohio ethanol credit that was limited to ethanol produced in Ohio or in other states that granted Ohio ethanol producers a similar credit).

[243] Michael Lang, *Double Tax Treaties and EC Law*, *in* COMPARATIVE FISCAL FEDERALISM 11, 13 (Reuven Avi-Yonah, James R. Hines, Jr. & Michael Lang eds., Kluwer 2007).

[244] In one ECJ case, an Advocate General's opinion had to be withdrawn and reissued because it was based on a misunderstanding of national tax law. *See* Antonello Lupo, *Reliefs from Economic Double Taxation on EU Dividends: Impact of the* Baars *and* Verkooijen *Cases*, 40 EUR. TAX'N 270, 273 (2000) (describing the nature of the error in the first opinion).

[245] *See* Hellerstein, *supra* note 96 (noting that the Supreme Court has applied ICT to both apportionment cases and substantive tax cases, but does not regularly apply it to either).

[246] *See, e.g.,* American Trucking Ass'ns, Inc. v. Michigan Public Serv. Comm'n, 545 U.S. 429 (2005); American Trucking Ass'ns. v. Scheiner, 483 U.S. 266 (1987) (lump sum taxes imposed upon trucks operating in-state); Tyler Pipe Indus. v. Washington Dept. of Revenue, 483 U.S. 232 (1987) (privilege taxes); Armco, Inc. v. Hardesty, 467 U.S. 638 (privilege taxes); Container Corp. of Am. v. Franchise Tax Bd., 463 U.S. 159 (1983) (apportionment formula).

[247] *See, e.g.,* Michael J. McIntyre & Richard D. Pomp, *State Income Tax Treatment of Residents and Nonresidents Under the Privileges and Immunities Clause*, 13 STATE TAX NOTES 245 (1997). Indeed, I would argue that use of CIST in the United States has resulted in the current sorry state of personal tax discrimination jurisprudence, almost universally bemoaned, including by the Supreme Court itself.

personal tax situations. Such cases implicate many of the same issues as cross-border apportionment cases, such as double taxation and mismatches between the tax laws of the various jurisdictions. Second, the stakes are higher in Europe than they are in the United States, since member state income taxes represent a much higher proportion of overall tax revenue than do state taxes in the United States. Finally, the United States has not needed to capitalize on the principal virtue of the internal consistency test: that it removes from consideration disharmonies between the laws of the source and residence state. In the United States, distortions from such disharmonies are less significant because the states generally use the federal tax base as a starting point for their tax assessments, and they employ formulary apportionment to avoid double taxation. In the European Union, in contrast, disharmonies between the source and residence rules of the various member states are pronounced. By analyzing the defendant state's tax system under the assumption that every other state has the same law, the internal consistency test removes the very disharmonies that serve as a distraction to the Court, leading it to err.

By providing a systematic way to distinguish between disparities and discriminations, the internal consistency test could bring much-needed clarity to the direct tax jurisprudence of the ECJ. The standard gives due regard to the reserved sovereignty of the member states to enact disparate tax legislation, but at the same time, it provides a standard by which to measure domestic tax rules for consistency with EC law. It would also reverse the inappropriate tendency of the Court in recent cases to analyze the laws of other member states when determining whether the defendant member state has discriminated. Whether a particular state violates the EC Treaty should be determined without regard to any offsetting tax advantages that may be independently available to taxpayers in other member states.