EUCOTAX Series on European Taxation

Comparative Fiscal Federalism

Comparing the European Court of Justice and the US Supreme Court's Tax Jurisprudence

Reuven S. Avi-Yonah
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A C.I.P Catalogue record for this book is available from the Library of Congress.

Published by
Kluwer Law International,
P.O. Box 316,
2400 AH Alphen aan den Rijn
sales@kluwerlaw.com
http://www.kluwerlaw.com

Sold and distributed in North, Central and South America by
Aspen Publishers, Inc.
7201 McKinney Circle,
Frederick, MD 21704,
USA

Sold and distributed in all other countries by
Turpin Distribution Services Limited
Stratton Business Park,
Pegasus Drive,
Biggleswade,
Bedfordshire SG18 8TQ,
United Kingdom

ISBN 978-90-411-2552-1

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VOLUME 14

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Preface

Reuven S. Avi-Yonah[1]

In October 2005, a group of distinguished tax experts from both the European Union and the United States convened at the University of Michigan Law School for a conference on 'Comparative Fiscal Federalism: Comparing the US Supreme Court and European Court of Justice Tax Jurisprudence.' The conference was sponsored by the Law School, the European Union Center, and Harvard Law School's Fund for Tax and Fiscal Research. Attendees from Europe included Michel Aujean, the principal tax official at the EU Commission, Servaas van Thiel, chief tax advisor to the EU Council, Michael Lang (Vienna) and Kees van Raad (Leiden), who run the two largest tax LLM programs on the European continent, and many other distinguished guests. The US contingent included Michael Graetz of Yale Law School, Alvin Warren of Harvard Law School, Walter Hellerstein of the University of Georgia (widely recognized as the preeminent US state tax scholar), and other important academics. Michigan was represented by Kyle Logue and Daniel Halberstam of the Law School, James Hines of the Economics Department, and myself as conference organizer.

The impetus for the conference, the first of its kind, was a series of decisions by the European Court of Justice (ECJ) in the last twenty years, but with increasing frequency in the last five. In those decisions the ECJ interpreted the Treaty of Rome (the 'constitution' of the EU) aggressively to strike down numerous Member State income tax rules on the ground that they were discriminatory. For example, the ECJ ruled that Finland cannot grant tax credits for corporate tax paid to Finnish shareholders, but refuse them to foreign shareholders. In another case, the ECJ struck down Germany's rules that restricted the deductibility of interest to foreign lenders, even though the rules also applied to tax-exempt domestic lenders.

When we compare this line of cases to the US Supreme Court's treatment of state taxes under the US Constitution (most often under the Commerce Clause, but

1. Reuven Avi-Yonah is the Irwin I. Cohn Professor of Law and Director of the International Tax LLM Program at the University of Michigan.

sometimes under the Equal Protection and Due Process Clauses), the difference is striking. In general, the Supreme Court has granted wide leeway to the states to adopt any tax system they wish, only striking down the most egregious cases of discrimination against out of state residents. Thus, for example, the Court has refused to intervene against rampant state tax competition to attract business into the state. It has twice upheld a method of calculating how much of a multinational enterprise's income can be taxed by a state that is widely seen as both incompatible with the methods used by the Federal government and other countries, and as potentially producing double taxation. And it has allowed states to impose higher income taxes on importers than on exporters through the use of so-called 'single factor sales formulas', under which a business pays tax to the state only if it makes sales to residents of the state, but not if it makes sales outside the state.

The conference was an attempt to gather together the best experts on both EU and US state taxation to explore these differences and what may be the underlying motivation. This book is the result. I hope this conference and book is just the beginning of a series of discussions between EU and US tax experts on these important issues.

I would like to thank my co-editors, James Hines and Michael Lang, and the contributors and participants in the conference for making the book possible.

I would also like to thank Dean Evan Caminker, the University of Michigan Law School and the Harvard Law School Fund for Tax and Fiscal Research for their generous support. Finally, I would like to thank Friederike Oberascher, Angelika Schlögl - Jettmar, Christoph Schlager and Marie-Ann Mamut of Vienna Economic University for their editorial help and Margaret Klocinski of the University of Michigan and Lijntje Zandee of Kluwer Law International for superb editing support.

Introduction

James R. Hines, Jr.

In tax matters, as in so many of life's matters, Europe and the United States display a comfortable similarity that makes the residual differences provocative and interesting rather than discordant and disturbing. Since Europe and the United States face many of the same tax problems, but resolve them independently, there is much to be gained from understanding the reasons why European and American tax policies, and tax jurisprudence, differ in the way that they do. Europe and the United States approach fiscal federalism rather differently, particularly in recent years, and the point of this book is to subject their approaches to careful comparative scrutiny.

The European Union and the United States are both federalist systems, and, along with every other federalist system in the world today, both the European Union and the United States face difficult choices over how best to divide authority between centers and member states, and how exactly authority should be exercised. Tax matters have been the loci of many of the federalist battles of recent decades. It is understandable that taxation might provoke heated controversy, given the sheer magnitude of tax responsibilities in modern times, and sharp regional differences of opinion in tax matters. The European and American federations are both survivors of past wars, and while it may be fairly said that tax policy itself is unrelenting warfare, the goal of sensible legal design is to constrain the belligerents in ways that lend these fights better tone and higher purpose than they might otherwise have.

The European Court of Justice and the US Supreme Court exert jurisdiction over tax matters in their respective spheres, doing so on the basis of differing constitutional authorities, and in response to different economic and political realities. Despite differences in their situations, the European Court of Justice and the US Supreme Court struggle with many of the same issues and concerns. In both cases the courts are called upon to resolve conflicts, real and imagined, between the tax policies of member states, including conflicts that may arise when states compete

to attract economic activities and the tax bases that accompany them. Both courts bear the responsibility of preventing member states from imposing discriminatory tax burdens, however construed, on residents of other member states. Both courts need to strike appropriate balances between federal and state, and legislative and judicial, responsibilities in tax matters, and both operate in environments in which governments are chronically short of tax revenue.

One of the challenges in understanding comparative approaches to federalism is the absence of anything resembling a consensus over the structure of an ideal federalist system. It is clear that fiscal federalism, both in Europe and in the United States, remains a work in progress, but the ultimate outlines of the fiscal structures that these societies are building are hazy at best. Even in the absence of clear or final guidance from citizens and legislators it is necessary for courts to resolve contemporaneous tax disputes, and, in so doing, prod governments to clarify their objectives and the way in which they are willing to distribute authority to pursue those objectives. In time, we may settle on a shared understanding of how best to structure intergovernmental fiscal relations in a federation. In the meantime, we have to raise revenue in as fair and efficient a manner as possible, relying on the courts to help us do so.

This volume brings together scholars from both sides of the Atlantic to consider federalist tax jurisprudence as practiced in Europe and the United States. These essays display a broad range of shared concerns, which is not to say that the scholars agree on all points of substantive policy and interpretation. What can be said is that there is general agreement that the exercise of comparing the tax jurisprudence of the European Court of Justice and the US Supreme Court is likely to be informative and beneficial to all concerned.

The first part of the volume consists of three papers addressing the tax decisions of the European Court of Justice. Chapter One, by Claudio Sacchetto, offers an overview of areas of potential conflict between the tax claims of the European Union, as enshrined in the European Community (EC) Treaty and interpreted by the European Court of Justice, and domestic constitutional principles of member states. The European Court of Justice implements its decisions based on interpretations of the EC Treaty's four fundamental freedoms (freedom of establishment, free movement of workers, freedom to provide services, and free movement of capital and payments), along with the Treaty's prohibition on State aid, which together restrict the actions of member states. The chapter notes that this design for European taxation fits better with some domestic legal systems in Europe than it does with others. Limiting the scope of state action in fiscal affairs is more consistent with Anglo-Saxon systems that protect fundamental freedoms and rights from state encroachment than it is with continental legal systems that delineate overarching government fiscal responsibilities that can be pursued subject only to specified restrictions. Since it is unlikely that European legal systems will converge any time in the near future, the problem of reconciling these legal differences is one that will face European tax jurisprudence in the years ahead.

Chapter Two, by Michael Lang, addresses issues related to double taxation. The potential for double taxation arises whenever income is subject to more than

one taxing jurisdiction, commonly because a taxpayer resident in one country earns income in another. Since both source and residence countries have the ability, and often the inclination, to tax the same income, it is clear that fair and efficient taxation of international income requires the prevention, or at least the mitigation, of double taxation. The practical difficulty facing the European Union is that its member states relieve double taxation incompletely, doing so in quite different ways, and to differing degrees. One class of issues that the European Court of Justice has had to resolve, directly and indirectly in various of its rulings, concerns whether the EC treaty obliges member states to relieve double taxation, or to adopt measures to ensure that all income is taxed at least once. The chapter reports that the European Court of Justice has not interpreted the EC treaty to require either the mitigation of all double taxation or the taxation of all income, instead ruling in ways that attempt to make national tax systems cohere in a fashion broadly consistent with the treaty.

In most of the world, international tax treaties play important roles in reducing double taxation and thereby facilitating international commerce. From the standpoint of the European Union, the ability of European countries independently to conclude treaties with each other, and with countries outside of Europe, raises the possibility that the impact of these treaties will be to produce outcomes that are detrimental (or beneficial!) to Europe as a whole and to the furtherance of the freedoms represented in the EC treaty. The chapter offers a careful analysis of the impact of treaty provisions on issues such as discrimination that are central to several European Court of Justice decisions, and considers the criteria used by the Court in resolving issues raised by treaties. The unsettled nature of the case law and a number of the associated tax policy issues leaves this area very much in flux, even as its importance increases due to the expansion of membership in the European Union and the rate at which member countries conclude tax treaties with non-European countries. The chapter concludes with the observation that the European Court of Justice double taxation rulings have had the effect of limiting the ability of member states to conduct their own tax affairs in ways that effectively and efficiently collects tax revenue, suggesting that the likely outcome of such a dynamic is the centralization of tax authority in Europe.

One of the most important features of multilateral tax agreements, and international tax treaties, is the application of the principle of nondiscrimination. Nondiscrimination provisions protect foreign investors from arbitrary and capricious taxation by governments to which they have little if any political recourse. Chapter Three by Kees van Raad analyzes nondiscrimination as understood by the OECD Model Treaty and the EC Treaty. As a general matter, the OECD Model Treaty takes a considerably narrower view of the measures necessary to implement nondiscrimination than does the EC Treaty, at least as the EC Treaty is interpreted by the European Court of Justice. The chapter examines these differences in the application of nondiscrimination, and offers a constructive proposal for ways to meld the OECD and EC nondiscrimination provisions into something more coherent and sensible than what either provides independently at present.

The second part of the volume, consisting of Chapter Four by Walter Hellerstein, surveys federalism aspects of the tax jurisprudence of the US Supreme Court.

The US context is particularly noteworthy for its dearth of constitutional and legislative guidance in resolving issues related to fiscal federalism. Indeed, it is what the US Constitution omits, rather than what it says, that is understood to be the constitutional foundation of fiscal relations in the United States: the Commerce Clause gives Congress the authority to regulate interstate commerce, its silence on state authority taken to imply an absence of state authority. Chapter Four's sweeping survey of the history of this 'dormant' Commerce Clause, its interpretation and implications, runs from the earliest days of the Republic to modern times. This, together with the chapter's evaluation of the implications of the Constitution's clauses guaranteeing privileges and immunities to citizens of every state, and rights to due process, covers the foundation of federalist fiscal relations as practiced in the United States. As the chapter notes, the US Supreme Court, acting with the benefit of little Constitutional and legislative guidance, has had to find its own way through the thicket of federalist issues, a challenge it has met doggedly, if not always coherently.

The third part of the volume offers a comparison of tax decisions by the European Court of Justice and the US Supreme Court. Chapter Five, by Charles McLure, evaluates the practice of tax assignment in Europe and the United States, calling attention to the continuing impact of rules and practices adopted long ago in reaction to conditions at the time, but to which countries and courts still adhere. A desire to integrate European society in the 1950s as a way of preventing future conflicts, together with contemporaneous insistence on the part of national governments for the freedom to set tax policies to pursue independent national objectives, produced a structure in which there is considerable European policy coordination, but direct tax matters in the European Union require unanimous consent. The unanimity requirement impedes the type of tax policy coordination that the chapter argues is necessary for sensible and coherent taxation in Europe, though recent decisions by the European Court of Justice have been nudging policy in a direction that may ultimately mandate more active coordination. The legislative structure of the United States, adopted in an era in which federal tax collections on the modern scale were simply unthinkable, offers state governments few guarantees that the federal government will guard their fiscal interests. The tax policies of member states of both the European Union and the United States have features that are appropriate for independent jurisdictions, though perhaps less so for members of a federation, reflecting that many of these policies have been in place since earlier eras of less advanced economic integration.

Chapter Six by Tracy Kaye compares the application of nondiscrimination rules, reporting significant differences between the paths taken by the European Union and the United States. The chapter notes that the European Court of Justice intervenes actively to protect taxpayers from discriminatory treatment by member states, in the process, it argues, undermining the ability of European countries to collect revenue with sensible tax policies. The US Supreme Court applies less ambitious standards in preventing discrimination, thereby affording greater latitude for state tax policies. In neither the European nor the American case can it be said that there has emerged a fully coherent approach to fiscal federalism. The chapter

concludes that, given the current realities, the public finances of Europe would be strengthened by less active tax jurisprudence by the European Court of Justice, whereas those of the United States would benefit from greater judicial oversight by the Supreme Court.

Chapter Seven by Michael Graetz and Alvin Warren calls attention to one of the great difficulties facing the European Court of Justice in its effort to apply the EC Treaty's four freedoms to tax matters with international implications. The problem facing the European Court of Justice is that economic freedoms can be construed in multiple ways, and these interpretations carry differing tax policy implications. Specifically, it is impossible, in the absence of harmonized national tax systems, for all jurisdictions to provide equal tax treatment of income earned locally by all investors, regardless of nationality, while simultaneously imposing equal tax burdens on all income earned by residents, regardless of the locations in which earned. Since the EC Treaty's freedoms can be interpreted as mandating both of these neutral tax positions, their inconsistency virtually guarantees that an activist European Court of Justice will find grounds to strike national tax provisions other than those that are perfectly harmonized, rates and bases, with their neighbors. Such sweeping application of nondiscrimination principles has not been embraced by the US Supreme Court, which has reacted in part to the more limited approach to residence-based taxation used by American states. How and when Europe will find a stable solution to its tax policy problems may depend on future legislative and political compromises.

The fourth part of the volume contains ambitious prognostications of future tax developments in Europe and the United States. Chapter Eight by Michel Aujean reviews recent nondiscrimination rulings by the European Court of Justice, noting their impact in facilitating the international flow of economic resources in Europe, but also noting the problems that these rulings have posed for national tax systems. Extrapolating this trend, the chapter poses the question of how national governments in Europe are likely to react to continued interference from the Court that largely takes the form of finding for taxpayers in tax disputes. One possibility is that such developments may drive European governments to forge cooperative, or even Community-wide, agreements to harmonize, or systematize, their tax policies in ways that preserve tax revenues while withstanding judicial scrutiny.

Chapter Nine, by Servaas van Thiel, analyzes two specific issues that arise in applying nondiscrimination principles within the European Union. Given the ability of European countries to conclude bilateral tax treaties with other members of the European Union, it is possible that the terms of these treaties may afford taxpayers from one European country more favorable terms than taxpayers from another. Are such outcomes inconsistent with the principles embedded in the EC Treaty, and if so, then how might the inconsistencies be resolved? The chapter suggests that substantive differential treatment would, in principle, be inconsistent with the Treaty, but notes that most tax treaty provisions are not affected by an MFN obligation to the extent they allocate tax jurisdiction and avoid double taxation. The second issue that the chapter considers is the extent to which the EC Treaty obliges the European Court of Justice to require member governments to prevent double

taxation of income earned within Europe by residents of the European Union. The chapter notes that such an affirmative obligation is consistent with past Court findings, and offers guidelines on how the responsibility to remove double taxation might be assigned.

Chapter Ten, by Albert Rädler, analyzes in some detail the *D.* case, noting the willingness of the European Court of Justice, as evidenced by its holding, to permit countries to achieve with tax treaties some outcomes that would not be permitted if enacted by national laws. The chapter shares with its predecessor the forecast that there will be continuing judicial action on issues related to most-favored nation status within Europe, given the current potential for what many would view as discriminatory outcomes resulting from bilateral tax treaties.

Chapter Eleven, by Ruth Mason, considers the future of tax treaties among European countries and between European countries and the United States. The important functions of these tax treaties, the chapter argues, are at grave risk from future jurisprudence by the European Court of Justice. The Court has exhibited a willingness to take an activist stance toward national tax laws within Europe, and, since tax treaties are also under its jurisdiction, there is little to prevent the Court from disallowing bilateral tax treaty provisions that it finds to be inconsistent with the EC Treaty. In anticipation of such activism, the chapter notes that European countries might take steps to standardize the application of tax treaty benefits to all European nationals, or, more radically, conclude multilateral treaties within Europe and between the European Union and the United States. While there are clear obstacles to multilateralism on this scale, the chapter identifies benefits both for Europe and the United States that might, in the hands of thoughtful policymakers, make such multilateral tax agreements realistic possibilities.

The volume concludes with Chapter Twelve, by Reuven Avi-Yonah. This chapter poses the question of what the US Supreme Court and the European Court of Justice can learn from each other's jurisprudence. Following a thoughtful review of recent experience, the chapter finds that there is much that these two august institutions can learn from each other. As a general matter, the European Court of Justice has dealt roughly with the tax rules of member states, routinely siding with taxpayers who appeal their cases on the basis that national tax policies have discriminatory impact or in other ways impede their freedoms. The US Supreme Court, by contrast, has granted US states considerable discretion to pursue independent tax policies largely unimpeded by the imperatives of American federalism or the claims of unhappy taxpayers. Neither court has found a perfect solution to all of the challenges it faces, and perhaps both have gone too far, albeit in opposite directions. The chapter suggests that something between the European and American approaches might make sense for both courts to adopt, and that this outcome is made more likely by careful consideration of the lessons from across the Atlantic.

Table of Contents