TAX DISCRIMINATION: A COMPARATIVE ANALYSIS OF U.S. AND EU APPROACHES

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Table of Contents

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thank her research assistants Deirdre Bussom, Carolyn Conway, Andrew Farrelly, Wayne Jentis, Monica Kraft, Alison Lam, Victor Macam, Anneke Niemira, Aliza Sherman and Lynn Tatum.

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I. Introduction

Both the United States of America and the European Union were founded in part because of the need for economic unity.[1] The United States was formed in 1787 in hopes of a solution to "the mutual jealousies and aggressions of the States, taking form in customs barriers and other economic retaliation."[2] The U.S. Constitution, however, establishes the dual sovereignty of the states and the federal government and reserves to the states the power to define their own tax systems.[3]

More than one hundred and fifty years later, the founding countries of the European Economic Community strove to establish a common market in 1958.[4] The

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[1] On October 29, 2004, leaders from the 25 EU Member States officially signed the new European Constitution. Graham Bowley, *Heads of State Sign the European Union's First Constitution*, N.Y. TIMES, October 30, 2004, at A3. The Treaty Establishing a Constitution for Europe integrates the Treaty Establishing the European Community and the Treaty on the European Union and replaces the "co-decision procedure," among other procedural changes. JACQUES ZILLER, THE NEW EUROPEAN CONSTITUTION 17, 148 (Mel Marquis trans., 2004); *see also* Treaty Establishing a Constitution for Europe, Dec. 16, 2004, 2004 O.J. (C 310), *available at* http://europa.eu.int/constitution/en/lstoc1_en.htm. As of May 2006, 13 Member States had fully ratified the Constitution. The Constitution, which must be ratified by all 25 Member States to enter into effect, was rejected in referendums in France and the Netherlands. BBC News, *EU constitution*: *Where member states stand, available at* http://news.bbc.co.uk/2/hi/europe/3954327.stm. Although the ratification process has continued, several countries, including the United Kingdom, have indefinitely postponed their referendums. *Id.* The lack of a Constitution, however, does not greatly affect this chapter because "from a strictly normative viewpoint it has made little difference that the Community was established by a network of treaties rather than by a formal constitution." Eric Stein, *Treaty-Based Federalism, A.D. 1979: A Gloss on Covey T. Oliver at the Hughes Academy*, 127 U. PA. L. REV. 897, 901 (1979).

[2] Baldwin v. G.A.F. Seelig, Inc., 294 U.S. 511, 522 (1935) (citations omitted). See generally 2 THE RECORDS OF THE FEDERAL CONVENTION OF 1787, 308 (Max Farrand ed., 1911); 3 *id.* at 478, 547, 548; THE FEDERALIST NO. 42 (James Madison)).

[3] *See* 1 PAUL J. HARTMAN & CHARLES A. TROST, FEDERAL LIMITATIONS ON STATE AND LOCAL TAXATION § 1:1, at 4 (2d ed. 2003) ("[T]he Court has repeated . . . that the power to impose and collect taxes for the support of state government shall not be unduly curtailed.").

[4] *See* Treaty Establishing the European Economic Community, art. 2, Mar. 25, 1957, 298 U.N.T.S. 11 [hereinafter EEC Treaty]. The EEC Treaty established the European Economic Community as of January 1, 1958. *Id.* The objective of the EEC Treaty was to create a single common market that would increase the volume and gain from trade between the Member States. *Id.* The original Member States were Belgium, France, Federal Republic of Germany, Italy, Luxembourg, and the Netherlands. The United Kingdom, Ireland, and Denmark joined in 1973, Greece in 1981, and Spain and Portugal in 1986. EMILE NOEL, WORKING TOGETHER: THE INSTITUTIONS OF THE EUROPEAN COMMUNITY 5 (1993). Austria, Sweden, and Finland acceded to the EU on January 1, 1995. P.S.R.F. MATHIJSEN, A GUIDE TO EUROPEAN UNION LAW 21 (8th ed. 2004). The Czech Republic, Cyprus, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovakia and Slovenia joined on May 1, 2004. Roger J. Goebel, *Joining the European Union: The*

Single European Act[5] incorporated the objective of an internal market into the founding Treaty (known as the EEC Treaty).[6] Thus, the European Union (EU) also has evolved into a project for economic union.[7] To create such an economic union, the EEC Treaty contemplated the removal of obstacles to the free movement of goods, persons, services, and capital between the Member States.[8] These Treaty provisions are known as the "four freedoms" and, together with the freedom of establishment,[9] they constitute the fundamental rules of the European Community's internal market.[10]

Just as the U.S. Constitution established the dual sovereignty of the states and the federal government, the EEC Treaty also divided competencies between the Member States and the Community.[11] As a general matter, the Treaty provides no legal basis for the imposition of taxes by the Community itself.[12] The power to tax has been reserved to the Member States.[13] However, it is understood that the Community and the Member States share competencies in the income tax area such that both have the right to legislate, although Community measures in this respect are subject to the principle of subsidiarity.[14] The principle of subsidiarity requires that the Community only take action

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Accession Procedure for the Central European and Mediterranean States, 1 LOY. U. CHI. INT'L L. REV. 15 (2003-04).

[5] Single European Act, Feb. 17, 1986, 1987 O.J. (L 169) *amending* EEC Treaty, *supra* note 4 [hereinafter SEA]. The then twelve Member States signed the Single European Act in 1986. *Id.*

[6] SEA, *supra* note 5, art. 13. The internal market is defined as "an area without internal frontiers in which the free movement of goods, persons, services and capital is ensured . . . ." EEC Treaty, *supra* note 4, art. 7a (now art. 14.2).

[7] The 1992 amendment of the SEA by the Treaty of Maastricht established the European Union and became effective on November 1, 1993. Treaty on European Union, Feb. 7, 1992, 1992 O.J. (C 191) 1 [hereinafter TEU]. The Treaty of Amsterdam, effective May 1, 1999, amended and renumbered the EEC Treaty and the TEU. Treaty of Amsterdam, *amending* the Treaty on European Union, the Treaties Establishing the European Communities and Certain Related Acts, Oct. 2, 1997, 1997 O.J. (C 340) 1. The most recent revisions of the Treaty entered into force on February 1, 2003. Treaty of Nice, *amending* the Treaty on European Union, the Treaties Establishing the European Communities and Certain Related Acts, Feb.. 26, 2001, 2001 O.J. (C 80) 1 [hereinafter Treaty of Nice]. For a detailed analysis of the Treaty of Nice *see* Roger J. Goebel, *The European Union in Transition: The Treaty of Nice in Effect, Enlargement in Sight, a Constitution in Doubt,* 27 FORDHAM INT'L L.J. 455 (2004).

[8] EEC Treaty, *supra* note 4, art. 3(c) (now art. 3(1)(c)).

[9] The freedom of establishment is the freedom of a business established in one Member State to establish itself in another Member State. See *infra* notes 331-335 and accompanying text for a discussion of the freedom of establishment.

[10] GEORGE BERMANN ET AL., CASES AND MATERIALS ON EUROPEAN UNION LAW 451 (2d ed. 2002). *See also infra* notes 287-301 and accompanying text. "The Court refers to the four freedoms as 'fundamental principles of Community law' whose substance must be interpreted widely and exceptions narrowly." SERVAAS VAN THIEL, FREE MOVEMENT OF PERSONS AND INCOME TAX LAW: THE EUROPEAN COURT IN SEARCH OF PRINCIPLES 5 n.17 (2002) [hereinafter VAN THIEL, FREE MOVEMENT OF PERSONS].

[11] VAN THIEL, FREE MOVEMENT OF PERSONS, *supra* note 10, at 12.

[12] Michel De Wolf, *The Power of Taxation in the European Union and in the United States*, 3 EC TAX REV. 124 (1995). One exception is that Community civil servants pay income tax on their Community salaries to the Community instead of their Member States. MATHIJSEN, *supra* note 4, at 104. *See also* Council Regulation 260/68, 1968 O.J. (L 056) (EEC, Euratom, ECSC).

[13] "The sanctity of the Member States' power to levy direct taxes . . . is illustrated by the EC Treaty's almost complete silence on the subject." Jan Wouters, *The Case-Law of the European Court of Justice on Direct Taxes: Variations upon a Theme,* 1 MAASTRICHT J. EUR. & COMP. L. 179, 180 (1994).

[14] VAN THIEL, FREE MOVEMENT OF PERSONS, *supra* note 10, at 12. The drafters of the Maastricht Treaty on European Union (TEU) made the subsidiarity principle a central tenet of the Community's 1992

if the objectives cannot be sufficiently achieved by the Member States individually and can be better achieved (e.g., due to economies of scale) by the Community.[15] This criterion, however, can be satisfied where differences in national rules tend to distort the internal market. Therefore, the Community can exercise its legislative powers to eliminate any income tax obstacles to the intra-Community flow of goods, persons, services and capital.[16]

This chapter focuses on these two "federalist" systems and their respective approaches to thwarting tax discrimination. Like Congress, the Council of Ministers (comprised of representatives of the Member States at the ministerial level) has the power to regulate commerce between the Member States.[17] Nevertheless, despite several studies outlining the distortions to the internal market caused by tax differences,[18] the scope of EC direct tax legislation is currently very limited when compared to progress made in the value added tax area.[19] Many commentators blame the "continuous legislative vacuum in the income tax area" on the continued unanimity requirement for tax legislation.[20]

The European Court of Justice (ECJ) began filling this void by using directly applicable Community law to eliminate income tax barriers to the internal market.[21] As Community law has evolved, the Court has gradually expanded its role in the integration process and has begun rigorously to enforce a "constitutionally guaranteed minimum of economic integration in the form of directly applicable private sector rights to equal treatment and free movement."[22] Since 1986, more than thirty cases have come before the European Court of Justice testing the compatibility of various national tax provisions with the EC Treaty provisions on free movement of persons.[23] Taking into account all of

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constitutional reform. George A. Bermann, *Taking Subsidiarity Seriously: Federalism in the European Community and the United States*, 94 COLUM. L. REV. 332, 333-34 (1994).

[15] Consolidated Version of the Treaty Establishing the European Community, art. 5, O.J. (C 325) 33 (2002) [hereinafter EC Treaty], *incorporating changes made by* Treaty of Nice, *supra* note 7. The Community's activities are furthermore subject to the principle of proportionality, according to which "[a]ny action by the Community shall not go beyond what is necessary to achieve the objectives of this Treaty." *Id.*

[16] VAN THIEL, FREE MOVEMENT OF PERSONS, *supra* note 10, at 13. See *infra* notes 108-113 and accompanying text for a discussion of the various EC directives that have been implemented in the direct tax area.

[17] JAMES HANLON, EUROPEAN COMMUNITY LAW 36 (3d ed. 2003). *See also infra* notes 70-73 and accompanying text.

[18] *See, e.g.,* COMMISSION OF THE EUROPEAN COMMUNITIES, REPORT OF THE COMMITTEE OF INDEPENDENT EXPERTS ON COMPANY TAXATION (1992).

[19] *See infra* notes 109-113 and accompanying text.

[20] SERVAAS VAN THIEL, EU CASE LAW ON INCOME TAX PART I 425 (2001). "Due to the unanimity requirement it has been difficult in recent years to make progress in a number of areas in which action is urgently required to ensure the proper functioning of the internal market and the unfettered exercise of the Treaty freedoms." Communication from the Commission on Supplementary Contribution of the Commission to the Intergovernmental Conference on Institutional Reforms, Qualified Majority Voting for Single Market Aspects in the Taxation and Social Security Fields, at 5, COM (2000) 114 final (Mar. 14, 2000) [hereinafter Qualified Majority Voting Position Paper].

[21] VAN THIEL, *supra* note 20, at 425-26.

[22] 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, 4-5 (2003).

[23] VAN THIEL, FREE MOVEMENT OF PERSONS, *supra* note 10, at 5 n.16. The relevant tax cases referred by their name only are "Humblet, Commission v. France, Daily Mail, Krantz, Biehl, Bachmann, Commission

the four freedoms,[24] there have been approximately one hundred direct tax cases.[25] What is fascinating is that in all but about seven of these cases, the ECJ has struck down the national tax provision concerned, stating that it violated one of these Treaty freedoms.[26] "While European Union governments do their best to avoid harmonising taxation, the EU's court of justice is busy doing it for them."[27]

Although the United States has no such unanimity requirement for its tax legislation, there had been a similar legislative vacuum in the state tax area. Congress clearly has the authority to regulate commerce among the states under the Commerce Clause.[28] This authority includes the power to regulate cross-border transactions, even to the extent of prohibiting certain state taxes.[29] State tax laws enjoy no immunity from Congress's Commerce Clause powers.[30] However, Congress historically had used these powers sparingly.[31]

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v. Belgium, Werner, Commerzbank, Halliburton, Schumacker, Wielockx, Commission v. Luxembourg, Svensson, Asscher, Futura, Safir, Gilly, ICI, Terhoeve, Royal Bank of Scotland, Baxter, Gschwind, St Gobain, Eurowings, Vestergaard, XAB-YAB, Baars, Zurstrassen, Verkooijen, AMID, Metallgesellschaft/Hoechst." *Id.* Additional cases involving the free movement of persons are: Wallentin, De Baeck, Commission v. Federal Republic of Germany, Weigel, Mertens, Schilling, and de Groot.

[24] *See infra* notes 291-298 and accompanying text.

[25] *See, e.g.,* 2 MATERIALS ON INTERNATIONAL & EC TAX LAW (Kees van Raad ed., 5th ed. 2005). *See generally Court Cases in the Field of, or of Particular Interest for, Direct Taxation, at* http://europa.eu.int/comm/taxation_customs/resources/documents/taxation/gen_info/tax_law/legal_proceedings/court_cases_direct_taxation_en.pdf (last visited Sept. 16, 2005).

[26] *See* Cordia Scott, *Europe's Changing View of Nondiscrimination May Color Future Tax Treaty Talks*, 33 TAX NOTES INT'L 851, 852 (2004); *see, e.g.*, Case 81/87, The Queen v. H. M. Treasury and Comm'rs of Inland Revenue, *ex parte* Daily Mail and General Trust plc, 1988 E.C.R. 5483; Case C-204/90, Bachmann v. Belgium, 1992 E.C.R. I-249; Case C-112/91, Werner v. Finanzamt Aachen, 1993 E.C.R. I-429; Case C-336/96, Gilly v. Directeur des services fiscaux du Bas-Rhin, 1998 E.C.R. I-2793; Case C-391/97, Gschwind v. Finanzamt Aachen-Auβenstadt, 1999 E.C.R. I-5451; Case C-403/03, Egon Schempp v. Finanzamt Munchen V, 2005 E.C.R. 00000; Case C-376/03, D. v. Inspecteur van de Belastingdienst, 2005 E.C.R. 00000.

[27] *Taxing Judgments,* THE ECONOMIST, August 28, 2004, at 67. Since 2000, the ECJ has taken on national tax laws addressing thin capitalization (*see, e.g.*, Case C-324/00, Lankhorst-Hohorst GmbH v. Finanzamt Steinfurt, 2002 E.C.R. I-11779), interest deductibility (*see, e.g.,* Case C-168/01, Bosal Holding BV v. Staatssecretaris van Financiën, 2003 E.C.R. I-9409), and exit taxes (*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). *Id.* at 67-68. *See also* Lee A. Sheppard, *Dowdy U.K. Retailer Set to Destroy European Corporate Tax*, 35 TAX NOTES INT'L 132 (2004).

[28] U.S. CONST. art. I, § 8, cl. 3 [hereinafter Commerce Clause]. *See infra* note 187.

[29] *See Congressional Power to Proscribe Certain State Taxes, State Taxation of Nonresidents' Pension Income: Hearings Before the Subcomm. on Economic and Commercial Law of the House Comm. on the Judiciary,* 103d Cong. 99, 100 (1993) (legal memorandum by Johnny Killian, Senior Specialist, American constitutional law, Cong. Res. Serv., Lib. of Cong.) (citing Champion v. Ames, 188 U.S. 321 (1903)). This memorandum [hereinafter *CRS Memo I*] provides a brief but comprehensive discussion of federal preemption in the area of state taxation. *See also* Kathryn Moore, *State and Local Taxation: When Will Congress Intervene*, 23 J. LEGIS. 171 (1997) (reviewing the legislative history of various bills prohibiting state taxation); Charles E. McLure, Jr. & Walter Hellerstein, *Congressional Intervention in State Taxation: A Normative Analysis of Three Proposals*, 31 ST. TAX NOTES 721 (2004) (providing an overview of congressional intervention in state tax matters and analyzing congressional proposals regarding Internet access taxes, sales tax streamlining, and business activity taxes).

[30] *CRS Memo I, supra* note 29, at 100.

[31] *See* Moore, *supra* note 29, at 182. One notable exercise of its power occurred in 1959, when Congress passed a law preventing states from taxing corporations when the corporation's only nexus with the state

Given this historic reluctance of Congress to intervene in state taxation, the United States Supreme Court has been forced to examine issues similar to those now confronting the European Union. In 1871, the Court recognized the right of a citizen of one state to "be exempt from any higher taxes or excises than are imposed by the [other] State upon its own citizen."[32] For more than two centuries, there has been a stream of cases involving state taxation of interstate commerce.[33] The Supreme Court has had to interpret "constitutional provisions directed to concerns far broader than taxation alone,"[34] thus creating virtually all of the federal restraints that exist on the states' taxing power.[35]

In this chapter, I examine whether the ECJ has been able to handle tax discrimination more effectively than the U.S. Supreme Court. I thought this research might prove fertile because the time span of consideration of these issues was so compressed in the European Union. It has only been approximately 20 years since the first EU tax case as compared to over 200 years of U.S. jurisprudence.[36]

Unlike the U.S. Supreme Court, the European Court of Justice is obligated under the Treaty to take every case that is referred to it under Article 234 of the EC Treaty.[37] Although EU nationals in general must litigate before their respective domestic courts, the highest courts or tribunals must refer questions regarding the incompatibility of Member States' domestic law or tax treaties with the EC Treaty to the ECJ if such questions arise in the national proceedings.[38] The goal is to secure uniform interpretation of the Treaty by the national courts and tribunals.[39] Along with these referrals, the ECJ must also hear cases brought by the Commission pursuant to its obligation to enforce the Treaty.[40] The Commission has stated that it intends to pursue a more proactive strategy

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was personal property sales solicitations conducted in the state. *See* Act of Sept. 14, 1959, Pub. L. No. 86-272, 73 Stat. 555-56 (codified as amended at 15 U.S.C. §§ 381-384 (1976)). Congress was responding to business concerns that mere solicitation within a state would establish a tax nexus following the Supreme Court's decision in Northwestern States Portland Cement Co. v. Minnesota, 358 U.S. 450 (1959) (holding that net income from interstate operations of a foreign corporation is properly subject to state taxation if apportioned to local activities forming a sufficient nexus with that state). *See CRS Memo I, supra* note 29, at 103-04. For more recent activity in Congress, see *infra* Part II.

[32] Ward v. Maryland, 79 U.S. (12 Wall.) 418, 430 (1871) (holding that a Maryland statute requiring nonresident traders pay a higher licensing fee than resident traders was in violation of the Privileges and Immunities and Commerce Clauses).

[33] *See generally* Walter Hellerstein, *State Taxation of International Business: Perspectives on Two Centuries of Constitutional Adjudication,* 41 TAX LAW. 37 (1987) [hereinafter Hellerstein, *State Taxation*].

[34] Walter Hellerstein, *Federal Limitations on State Taxation of Interstate Commerce, in* COURTS AND FREE MARKETS 431 (Terrence Sandalow & Eric Stein eds., 1982) [hereinafter Hellerstein, *Federal Limitations*].

[35] *Id.*

[36] Hellerstein, *State Taxation, supra* note 33, at 40.

[37] EC Treaty, *supra* note 15, art. 234.

[38] *Id.* Lower courts and tribunals may also refer such questions to the ECJ. The interpretation of Article 234 determines which questions must be subject to a preliminary ruling and those questions for which a preliminary ruling by the ECJ may be requested by a national court or tribunal. P.J.G. KAPTEYN & P. VERLOREN VAN THEMAAT, INTRODUCTION TO THE LAW OF THE EUROPEAN COMMUNITIES: FROM MAASTRICHT TO AMSTERDAM 517 (3d ed. 1998).

[39] Case 26/62, Van Gend en Loos v. Nederlandse Administratie Der Belastingen, 1963 E.C.R. 1, ¶ 10.

[40] EC Treaty, *supra* note 15, art. 220: "The Court of Justice shall ensure that in the interpretation and application of this Treaty the law is observed." *Id.* The Commission formulates Community policy, makes proposals to the Council, and drafts the detailed measures needed for their implementation. TREVOR C. HARTLEY, THE FOUNDATIONS OF EUROPEAN COMMUNITY LAW 16-18 (5th ed. 2003).

in the field of tax infringements and is more willing to initiate action before the Court upon finding incompatible tax provisions.[41]

In the U.S. judicial system, taxpayers normally have to challenge a state tax in state court.[42] The state courts review federal law in the course of deciding these cases, but are not required to get a ruling from the Supreme Court prior to issuing a decision.[43] A state court must "follow the Supreme Court's rulings on the meaning of the Constitution of the United States or federal law,"[44] but the state court is doing the actual interpreting. After a loss in the state's highest court, either party has the right to petition the U.S. Supreme Court to grant certiorari to hear the case.[45] However, it is at the Supreme Court's discretion as to whether it should hear the case.[46] Thus, the U.S. Supreme Court does not proportionally rule on the same amount of tax cases as the ECJ because the U.S. Supreme Court declines to hear many tax cases.[47]

For all these reasons, I was hopeful that a more coherent theory might have developed in the European Union. Unfortunately, as described in Part IV, the jurisprudence is confused on both sides of the Atlantic. In Part II, I provide background for the reader unfamiliar with the European Union and outline the EU's distinctive institutional arrangements.[48] In Part III, I set forth the principles of international and interstate taxation that underlie the tax legislation that has been promulgated by the respective Member States and the U.S. states.[49]

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[41] Communication from the Commission to the Council, the European Parliament and the Economic and Social Committee: Tax Policy in the European Union - Priorities for the Years Ahead, Position Paper for the Commission, at 23, COM (2001) 260 final (May 23, 2001) [hereinafter Tax Policy in the EU]. In 2005, the Commission introduced four times as many cases to the ECJ than it had just two years prior. Michael Aujean, Conference at the University of Michigan School of Law: Comparing Fiscal Federalism: Comparing the European Court of Justice and the U.S. Supreme Court's Tax Jurisprudence (Oct. 21-22, 2005) (on file with author).

[42] The Tax Injunction Act holds that "the district courts shall not enjoin, suspend or restrain the assessment, levy or collection of any tax under State law where a plain, speedy and efficient remedy may be had in the courts of such State." 28 U.S.C. § 1431 (2004). By tempering the power of the federal courts over certain state actions, the Tax Injunction Act protects an inherent aspect of state sovereignty, the power to assess and levy state and local taxes. 17 CHARLES ALAN WRIGHT ET AL., FEDERAL PRACTICE AND PROCEDURE § 4237 (2d ed. 1988).

[43] R. ROTUNDA & J. NOWAK, TREATISE ON CONSTITUTIONAL LAW: SUBSTANCE AND PROCEDURE § 1.6, at 70 (3d ed. 1999). "When reviewing federal laws these courts must follow the rulings of the Supreme Court and enforce federal laws over inconsistent state acts." *Id.*

[44] *Id.* States are free to interpret their own law or constitution in ways that do not violate the principles of federal law. This includes granting greater rights than the Federal Constitution provides. *Id.* The Supreme Court was granted the appellate jurisdiction over state court decisions with respect to federal questions in the Judiciary Act of 1789. 1 LAURENCE H. TRIBE, AMERICAN CONSTITUTIONAL LAW § 3-4, at 255 (3d ed. 2000).

[45] ROBERT L. STERN ET AL., SUPREME COURT PRACTICE § 1.19, at 54 (8th ed. 2002). "[T]he Supreme Court cannot possibly hear arguments in and decide more than a small proportion of the cases in which parties would like to bring before it. The consequence is that every type of case . . . goes through a preliminary sifting process." *Id.* Only those cases deemed "sufficiently important or meritorious to warrant further review" are granted the writ of certiorari. *Id.*

[46] "Review on writ of certiorari is not a matter of right, but of judicial discretion. A petition for a writ of certiorari will be granted only for compelling reasons." SUP. CT. R. 10.

[47] BOB WOODWARD & SCOTT ARMSTRONG, THE BRETHREN 362 (1979) (stating that Justice Brennan hated tax cases, and that his normal reaction to a certiorari request in a tax case was: "This is a tax case. Deny.").

[48] *See infra* Part II.

[49] *See infra* Part III.

In Part IV, I outline how the Supreme Court and the European Court of Justice have struggled with the conflict between these generally accepted tax principles and the effective prevention of discriminatory treatment of foreign source income.[50] For example, it has been accepted under international tax law that nonresident taxpayers are in a different situation than resident taxpayers and the taxation of nonresidents can be different than that of resident taxpayers.[51] This creates a conflict between these generally accepted tax principles and the effective prevention of discriminatory treatment of foreign source income.[52]

In Part V, I choose the most recent Supreme Court case that deals with individual tax discrimination and then examine the ECJ jurisprudence to determine how the European Court of Justice would decide the issue.[53] Although the ECJ approach yields much certainty (the national tax provision is generally found to violate the Treaty), it does not appear to solve the discrimination problem. Because progress has been made towards an internal market, I believe that the EU would be better served by harmonization at the legislative level. At a minimum, the ECJ should, at this point, give more deference to Member State tax systems. On the other hand, given the recent U.S. experience with federal intervention in state tax legislation and the current anti-tax rhetoric, the United States is better served by judicial oversight instead of the congressional interference that has restricted the ability of the states to levy necessary taxes. I conclude with a recommendation that the Supreme Court should give more priority to state tax conflicts and additional restraints should be placed on the ability of Congress to tamper with state tax laws.

II. EU vs. U.S. Federalism

Although the European Economic Community was principally designed for economic purposes, the idea of a political union was in the minds of many of its founders.[54] France's foreign minister Robert Schuman believed that economic unity would be the "leaven from which may grow a wider and deeper community between countries."[55] The Preamble to the 1957 Treaty Establishing the European Economic

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[50] *See infra* Part IV.

[51] BEN J.M. TERRA & PETER J. WATTEL, EUROPEAN TAX LAW 45-46 (3d ed. 2001).

[52] Peter J. Wattel, *The EC Court's Attempts to Reconcile the Treaty Freedoms with International Tax Law*, 33 C.M. L. REV. 223, 224-26 (1996).

[53] *See infra* Part V.

[54] BERMANN, *supra* note 10, at 3. In 1955, the Benelux countries proposed a path to political integration through economic integration. *Id.* at 6. Robert Schuman and Jean Monnet were the driving forces behind the establishment of the European Coal and Steel Community (ECSC) in 1950. RICHARD MAYNE & JOHN PINDER, FEDERAL UNION: THE PIONEERS: A HISTORY OF FEDERAL UNION 123-27 (1990). The ECSC's founding member states, including France, Italy, and Germany, intended the Community to be much more than an economic union. The intention was for a political union to ensure peace on the continent. *Id.*

[55] Pascal Fontaine, *Europe: A Fresh Start; The Schuman Declaration 1950-1990*. Luxembourg: Office for Official Publications of the European Communities (1990), citing the Schuman Declaration of May 9, 1950. Schuman proposed:

> [T]hat Franco-German production of coal and steel as a whole be placed under a common High Authority, within the framework of an organization open to the participation of the other countries of Europe. The pooling of coal and steel production should immediately provide for the setting up of common foundations for economic development as a first

Community aspires to the achievement of "an ever closer Union among the peoples of Europe."[56] The European Economic Community has evolved from a "common market" to an "internal market" to an "Economic and Monetary Union" to a "European Union."[57] It "represents the most ambitious example of deliberate political and economic integration in recent times," having created a "fully-developed form of federation in a matter of three to four decades."[58]

The United States's form of federalism has also evolved but over the last two hundred years. Some have forgotten how powerful the individual states were before the founding of the United States.[59] The states printed their own currency,[60] had their own courts,[61] and formed their own militia.[62] James Madison's basic thesis in *The Federalist Papers* was that "the powers delegated by the proposed Constitution to the Federal Government, are few and defined. Those which are to remain in the State Governments are numerous and indefinite."[63] Admittedly, these individual states did not have the duration of independent history that the Member States possessed at the formation of the European Economic Community.

A. The Legislative Branch

The EEC Treaty established an institutional system that enables the Community to enact legislation that is equally binding on all its members.[64] After the European Court of Justice's landmark decision on direct applicability, it is understood that the Treaty grants rights and imposes obligations on individuals, Member States, and

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> step in the federation of Europe, and will change the destinies of those regions which have long been devoted to the manufacture of munitions of war, of which they have been the most constant victims.
>
> The solidarity in production thus established will make it plain that any war between France and Germany becomes not merely unthinkable, but materially impossible. The setting up of this powerful productive unit, open to all countries willing to take part and bound ultimately to provide all the member countries with the basic elements of industrial production on the same terms, will lay a true foundation for their economic unification.

EUROPA, The EU at a Glance, Declaration of 9 May 1950, *available at* http://europa.eu.int/abc/symbols/9-may/decl_en.htm.

[56] EEC Treaty, *supra* note 4, Preamble.

[57] BERMANN, *supra* note 10, at 17.

[58] *Id.* at 27.

[59] "It was loyalty to one's country that moved men, whether radical or conservative, and one's country was the state in which one lived, not the thirteen more or less united states along the Atlantic Coast." MERRILL JENSEN, THE ARTICLES OF CONFEDERATION: AN INTERPRETATION OF THE SOCIAL-CONSTITUTIONAL HISTORY OF THE AMERICAN REVOLUTION 1774-1781, at 163 (1970).

[60] JEFFREY C. COHEN, POLITICS AND ECONOMIC POLICY IN THE UNITED STATES 36 (1997).

[61] *See* Ira Mickenberg, *Abusing the Exceptions and Regulations Clause: Legislative Attempts to Divest the Supreme Court of Appellate Jurisdiction*, 32 AM. U. L. REV. 497, 511 (1983).

[62] LAWRENCE D. CRESS, CITIZENS IN ARMS 63 (1982).

[63] JOSEPH M. LYNCH, NEGOTIATING THE CONSTITUTION: THE EARLIEST DEBATES OVER ORIGINAL INTENT 1 (1999) (citing THE FEDERALIST NO. 45, at 308, 313 (James Madison)).

[64] KLAUS-DIETER BORCHARDT, EUROPEAN INTEGRATION: THE ORIGINS AND GROWTH OF THE EUROPEAN UNION 26 (1995) [hereinafter EUROPEAN INTEGRATION]. Community law either has direct internal effect as law in the Member States or requires the Member States to implement the legislation domestically. EEC Treaty, *supra* note 4, arts. 5, 189 (now arts. 10, 249).

Community institutions.[65] "[T]his Treaty is more than an agreement which merely creates mutual obligations between the contracting States."[66] Instead, "the Community constitutes a new legal order of international law for . . . which the states have limited their sovereign rights . . . ."[67] Community law is comprised of basic legislation, including the treaties and their protocols, and secondary legislation that is the legislative product of the Community institutions.[68] The three Community institutions most involved in the legislative process are the Council of Ministers, the Commission, and the European Parliament.[69]

The Council of Ministers is comprised of representatives of the Member States, usually the ministers responsible for the subject matter under discussion.[70] For example, the Member States' Finance Ministers meet with respect to tax and other economic matters and are known as the Economy and Finance Council (ECOFIN).[71] Thus, the Council is set up in a manner that should enable it to safeguard the economic interests of the Member States because a minister's acknowledged responsibility is to look after a Member State's interests in the matter before the Council.[72] In tax matters, the Council is the principal lawmaking body of the Community, but it can only act on a proposal from the Commission.[73]

The Commission consists of members appointed by mutual agreement between member governments for five-year terms.[74] These Commissioners are required to act in complete independence of their own governments and the Council, and for the good of

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[65] Case 26/62, Van Gend en Loos v. Nederlandse Administratie Der Belastingen, 1963 E.C.R. 1. The doctrines of direct applicability, direct effect, and supremacy not only describe legal relationships, but actually demand Member State action. These doctrines "essentially require, respectively, that national institutions recognize Community measures as law, effectuate those measures at the request of private parties wherever appropriate, and prefer claims based on Community law to those based on Member State law whenever a choice must be made." Bermann, *supra* note 14, at 349.

[66] Case 26/62, Van Gend en Loos v. Nederlandse Administratie Der Belastingen, 1963 E.C.R. 1, ¶ 9.

[67] *Id.* ¶ 10.

[68] Tracy A. Kaye, *European Tax Harmonization and the Implications for U.S. Tax Policy*, 19 B.C. INT'L & COMP. L. REV. 109, 122 (1996) [hereinafter Kaye, *European Tax Harmonization*]. Secondary Community legislation consists of regulations, directives, decisions, recommendations, and opinions. EC Treaty, *supra* note 15, art. 249.

[69] BERMANN, *supra* note 10, at 34; HARTLEY, *supra* note 40, at 41; *see also* EC Treaty, *supra* note 15, art. 7. Most regulations are made by the Commission and are binding on all Member States without any further action by the individual states. *Id*. (expressly providing that regulations are directly applicable). Directives create obligations on the governments of the Member States to transpose the provisions adopted by the Community into national legislation. Directives are binding upon the Member States as to the result to be achieved but leave the national authorities free to choose the form and methods of compliance. *Id.* Decisions are binding on the specific entities to whom they are addressed. *Id. See also* NOEL, *supra* note 4, at 9. Recommendations and opinions are not legally binding but are issued by the Commission and Council to advise on specific topics. EC Treaty, *supra* note 15, art. 249.

[70] EC Treaty, *supra* note 15, art. 203; *see* EUROPEAN INTEGRATION, *supra* note 64, at 26; HARTLEY, *supra* note 40, at 19.

[71] *See Lobbying,* in SINGLE EURO. MARKET REP., 2-A, 2-4 (Baker & McKenzie eds., 1989).

[72] *See* Bermann, *supra* note 14, at 395.

[73] BERMANN, *supra* note 10, at 35-36. "The framers of the EC Treaty had entrusted the Community's legislative powers chiefly to a Council of Ministers in which representatives of the Member States could unapologetically express and vote the political interests of the States they represented." Bermann, *supra* note 14, at 353 (citing EC Treaty, *supra* note 15, art. 146).

[74] EC Treaty, *supra* note 15, arts. 213, 214.

the Community.[75] The Commission formulates Community policy, makes proposals to the Council, and drafts the detailed measures needed for their implementation. The Commission must also ensure that the Treaties and Community law are respected and applied, and must act on any infringements.[76] This includes referring matters to the Court of Justice, if necessary.[77]

The European Parliament consists of 732 members directly elected in their Member States every five years.[78] Although the EEC Treaty originally defined the role of the European Parliament as advisory and supervisory,[79] the legislative role of the Parliament has been consistently increasing.[80] Currently, depending on the subject matter, legislation is adopted pursuant to one of six different legislative procedures spelled out under the EC Treaty.[81] The consultation procedure,[82] the co-operation procedure,[83] the co-decision procedure,[84] the approval procedure,[85] the simplified procedure,[86] and the procedure for implementing measures[87] differ principally with respect to the degree of power afforded the Parliament.[88]

Most Community legislation is made pursuant to the co-decision procedure, which emphasizes reaching agreement on a text approved by both the Parliament and the Council.[89] However, the consultation procedure applies to taxation.[90] Under this procedure, the Commission delivers a proposal such as a proposed directive to the Council.[91] The European Parliament is consulted and publishes an opinion accepting,

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[75] EC Treaty, *supra* note 15, art. 213; Treaty Establishing a Single Council and a Single Commission of the European Communities (Merger Treaty), Apr. 8, 1965, 1967 O.J. (152), art. 10(2); BERMANN, *supra* note 10, at 44; HARTLEY, *supra* note 40, at 11-12. *See also* EUROPEAN INTEGRATION, *supra* note 64, at 26.

[76] EC Treaty, *supra* note 15, art. 211. In 2002, the Commission proposed drafts for 54 directives, 193 regulations and 239 decisions, and in 2003 drafts for 491 legislative proposals and decisions. BERMANN, EUROPEAN UNION LAW 3 (Roger J. Goebel ed., 2d ed. Supp. 2004) [hereinafter GOEBEL SUPPLEMENT, EUROPEAN UNION LAW] (Professor Goebel's electronic Developments Update on file with author).

[77] EC Treaty, *supra* note 15, art. 226.

[78] EC Treaty, *supra* note 15, arts. 189, 190. The most recent election was held in June 2004. Lizette Alvarez, *'Enthusiasm' is Not a Candidate in Elections for European Union*, N.Y. TIMES, June 10, 2004, at A11.

[79] EEC Treaty, *supra* note 4, art. 137; BERMANN, *supra* note 10, at 51.

[80] BERMANN, *supra* note 10, at 51; EC Treaty, *supra* note 15, art. 192.

[81] *See* KLAUS-DIETER BORCHARDT, THE ABC OF COMMUNITY LAW 72 (5th ed. 1999) [hereinafter COMMUNITY LAW]*; see also* HARTLEY, *supra* note 40, at 41.

[82] EC Treaty, *supra* note 15, art. 250; *see also* COMMUNITY LAW, *supra* note 81, at 72; HARTLEY, *supra* note 40, at 41.

[83] EC Treaty, *supra* note 15, art. 252; *see also* HARTLEY, *supra* note 40, at 43.

[84] EC Treaty, *supra* note 15, art. 251; *see also* HARTLEY, *supra* note 40, at 43.

[85] COMMUNITY LAW, *supra* note 81, at 81-82; *see, e.g.,* EC Treaty, *supra* note 15, arts. 49, 105(6), 107(5), 214(2).

[86] COMMUNITY LAW, *supra* note 81, at 82; *see also* EC Treaty, *supra* note 15, art. 211.

[87] COMMUNITY LAW, *supra* note 81, at 82; *see also* EC Treaty, *supra* note 15, art. 202.

[88] PAUL CRAIG & GRAINNE DE BURCA, EU LAW TEXT, CASES AND MATERIALS 139 (3d ed. 2002).

[89] *Id*. at 144-46. *See* EC Treaty, *supra* note 15, art. 251.

[90] BERMANN, *supra* note 10, at 83.

[91] Directives do not directly amend national law; rather they obligate governments of the Member States to take implementing action to incorporate their provisions into their national legislation. Directives are the legislative instruments most commonly used to harmonize the Member States' legislation. *See* BERMANN, *supra* note 10, at 253. Nearly all of the steps taken to harmonize the tax laws to date have been achieved through the use of directives. *See generally* Kaye, *European Tax Harmonization, supra* note 68, at 124. When a Member State does not implement the directive into national law, the question arises as to whether

rejecting, or suggesting amendments to the proposal. The Economic and Social Committee must also be consulted for any legislation that directly affects "the establishment or functioning of the common market."[92] This Committee consists of representatives of various economic and social interests such as trade unions, employers' groups, consumer groups and the professions.[93] The Committee of the Regions, composed of representatives of regional and local entities within the Member States, may also be consulted.[94]

The Commission may amend the proposal to incorporate any changes. The Council then examines and votes upon the proposed directive.[95] The Treaty provides three different voting formulas: unanimity, simple majority, and qualified majority.[96] The Treaty article under which the legislation is enacted specifies the appropriate voting rule to be used.[97] Although the EEC Treaty has been amended on multiple occasions to provide for the adoption of various harmonization measures by only a qualified majority vote of the Council, a unanimous vote is still required by the EC Treaty for tax legislation.[98] In fact, the Commission has proposed qualified majority voting for the introduction of minimum requirements in the tax area and the adoption of coordinating provisions to remove direct obstacles to the exercise of the four freedoms but has so far been unsuccessful.[99]

The European Council convened an intergovernmental conference (IGC) in Nice to discuss, among other issues, extension of qualified majority voting to various legislative areas.[100] An IGC is a meeting of representatives of each Member State for the purpose of

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the directive has direct effect, i.e., whether it is effective without such enactment. The European Court of Justice has observed that "a Member State which has not adopted the implementing measures required by [a] directive within the prescribed period may not plead, as against individuals, its own failure to perform the obligations which the directive entails." Case 8/81, Becker v. Finanzamt Munster Innenstadt, 1982 E.C.R. 53, ¶ 24 (holding that although Germany had not yet implemented the Sixth VAT Directive, the directive was directly effective). The test is whether the provisions of the directive are unconditional and sufficiently precise to be relied upon in a conflict with an incompatible national provision. *Id*. ¶ 25.

[92] EC Treaty, *supra* note 15, art. 94.

[93] EC Treaty, *supra* note 15, art. 257; *see also* HANLON, *supra* note 17, at 56-57.

[94] BERMANN, *supra* note 10, at 71-72. Articles 198a-198c of the TEU established the Committee of the Regions to provide nonbinding advisory opinions on matters having a particular effect on regions of the EU. HANLON, *supra* note 93, at 57; *see also* EC Treaty, *supra* note 15, arts. 263-265.

[95] EC Treaty, *supra* note 15, art. 250; *see also* HARTLEY, *supra* note 40, at 41; BERMANN, *supra* note 10, at 83.

[96] CRAIG & DE BURCA, *supra* note 88, at 153.

[97] *Id.* at 154.

[98] EC Treaty, *supra* note 15, art. 94 (ex art. 100). Article 94 states:

> "The Council shall, acting unanimously on a proposal from the Commission and after consulting the European Parliament and the Economic and Social Committee, issue directives for the approximation of such laws, regulations or administrative provisions of the Members States as directly affect the establishment or functioning of the common market."

Id. It is understood that Article 94 of the Treaty in the chapter on "Approximation of Laws" provides a legal basis for direct taxation harmonization measures. VAN THIEL, FREE MOVEMENT OF PERSONS, *supra* note 10, at 112.

[99] Qualified Majority Voting Position Paper, *supra* note 20, at 5, 11. "[I]t remains the Commission's view that a move to qualified majority voting at least for certain tax issues is indispensable." Tax Policy in the EU, *supra* 41, at 9.

[100] *See* BERMANN, *supra* note 10, at 24 (citing TEU, *supra* note 7, art. 48).

negotiating new amendments to the treaties.[101] The Commission was disappointed in the outcome of the treaty negotiations with respect to decision-making for tax issues at the 2000 IGC as no changes were made for tax legislation.[102]

The draft European Union Constitution briefly contained a provision that would have moved certain areas of legislation that affect the single market to majority voting, such as corporate taxes.[103] However, this provision did not survive the final negotiations because the United Kingdom and Ireland vetoed it.[104] The Commission remains committed to a move to qualified majority voting for certain tax issues, pointing out that EU enlargement will only exacerbate the inability to have agreement on any new Community tax legislation.[105]

Although the Treaty specifically covers indirect taxes,[106] Article 293 contains the only explicit reference to direct taxes and provides that Member States shall enter into negotiations to eliminate double taxation.[107] It is understood, however, that Article 94 of the Treaty, in the chapter on "Approximation of Laws," also provides a legal basis for direct taxation harmonization measures. This Article authorizes the Council, acting unanimously on a proposal from the Commission, to issue directives for the approximation of laws that "directly affect the establishment or functioning of the common market."[108] Thus, the Council has the power to regulate commerce between the Member States to the extent consistent with the Treaty.

Unfortunately, the scope of EC direct tax legislation is currently limited to a few corporate tax directives,[109] a savings directive,[110] and a mutual assistance directive.[111] There is an additional mutual assistance directive that enables tax authorities to assist

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[101] *Id.* at 31.

[102] Tax Policy in the EU, *supra* note 41, at 5.

[103] *Charlemagne: The Tyranny of the Majority,* THE ECONOMIST, May 29, 2004, at 55.

[104] GOEBEL SUPPLEMENT, EUROPEAN UNION LAW, *supra* note 76, at 445-522 (2d ed. Supp. 2004). *See also* Chuck Gnaedinger, *EU Convention Adopts Draft Constitution*, 31 TAX NOTES INT'L 206, 206 (2003) ("[qualified majority voting] for all tax legislation is not included in the draft text because of opposition from the United Kingdom and Ireland.").

[105] Tax Policy in the EU, *supra* note 41, at 22. "Since the legal basis will, for the present, remain unanimity it will, after enlargement, be much more difficult to have any new Community legislation agreed." *Id.* at 5. The most recent accession on May 1, 2004, enlarged the EU from 15 to 25 Member States. Goebel, *supra* note 4, at 15.

[106] For example, Article 90 states that Member States may not use internal taxes to discriminate against products coming from other Member States. EC Treaty, *supra* note 15, art. 90.

[107] EC Treaty, *supra* note 15, art. 293. This Article was the legal basis for Convention 90/436 on the Elimination of Double Taxation in Connection with the Adjustments of Transfers of Profits Between Associated Undertakings, July 23, 1990, 1990 O.J. (L 225) 10 [hereinafter Arbitration Convention]. *See infra* note 113 and accompanying text.

[108] EC Treaty, *supra* note 15, art. 94.

[109] Council Directive 90/435, 1990 O.J. (L 225) 6 (EEC) [hereinafter Parent-Subsidiary Directive], *amended by* Council Directive 2003/123, 2004 O.J. (L 7) 41 (EC); Council Directive 90/434, 1990 O.J. (L 225) 1 (EEC) [hereinafter Mergers Directive], *amended by* Council Directive 2005/19, 2005 O.J. (L 58) 19 (EC); Council Directive 2003/49, 2003 O.J. (L 157) 49 (EC) (Interest and Royalty Directive). "Unlike VAT, direct taxation is at a purely embryonic stage of harmonization." Case C-279/93, Finanzamt Köln-Altstadt v. Schumacker, 1995 E.C.R. I-225, Op. ¶ 19.

[110] Council Directive 2003/48, 2003 O.J. (L 157) 38 (EC) (Savings Directive).

[111] Council Directive 77/799, 1977 O.J. (L 336) 15 (EEC) (Mutual Administrative Assistance and Exchange of Information Directive), *amended by* Council Directive 79/1070, 1979 O.J. (L 331) 8 (EEC).

each other in the collection of tax claims.[112] On July 23, 1990, the Member States also concluded the Arbitration Convention to provide for binding arbitration of transfer pricing disputes when the respective tax authorities have been unable to resolve the issues within two years.[113]

Unlike the EU, where the Member States play a double role, decision-making in the U.S. Congress is currently independent from that of the fifty states.[114] Originally, the U.S. Constitution required that two Senators were to be chosen by the legislatures of each respective state because the Framers wanted to safeguard the interests of the state governments.[115] In 1787, the state legislative election of Senators was seen as a "central device for the protection of States' rights and interests."[116] However, in 1913, the states ratified and added the Seventeenth Amendment to the Constitution calling for the direct election of Senators.[117] There were a number of reasons for the adoption of the Seventeenth Amendment and the move to direct elections including: "(1) the perception that bribery and corruption had tainted the state legislatures' choice of Senators;" and "(2) the related belief that private interest groups dominated state legislatures to the point where senatorial choices did not adequately represent ordinary citizens."[118] Now, however, special interests in Washington are overshadowing the needs of the state government. Professor Vikram Amar observes that unfunded federal mandates and federal conscription of the states are a result of removing the state legislatures from the electoral loop.[119]

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[112] Council Directive 76/308, 1976 O.J. (L 73) 18 (EEC) (Mutal Assistance for the Recovery of Claims Directive), *amended by* Council Directive 2001/44, 2001 O.J. (L 175) 17 (EC). *See also* Jan de Goede, *European Integration and Tax Law,* 43 EUR. TAX'N 205 (2003).

[113] Arbitration Convention, *supra* note 107, at 10. Unlike the Parent-Subsidiary Directive and the Mergers Directive, the Arbitration Convention is actually a multilateral treaty. A.P. LIER ET AL., TAX AND LEGAL ASPECTS OF EC HARMONIZATION 159 (A.P. Lier ed., 1993). When the original Arbitration Convention expired at the end of 1999, the 1999 Protocol was signed by most of the Member States to extend its applicability. Pietro Antonini & Maurizio Di Bernardo, *Italy Ratifies Protocol to EU Arbitration Convention*, 34 TAX NOTES INT'L 912 (2004). As of November 1, 2004, the Arbitration Convention re-entered into force, having been ratified by all Member States. European Commission, *EU Joint Transfer Pricing Forum: Secretariat Discussion Paper on the Re-Entry into Force of the Arbitration Convention*, August 25, 2004, JTPF/019/2004. The Arbitration Convention will apply retroactively to January 1, 2000, with some limitations. *Id.*

[114] *See* Koen Lenaerts, *Constitutionalism and the Many Faces of Federalism*, 38 AM. J. COMP. L. 205 (1990) ("the political reality that decision-making within the American Union is organically independent from the States, whereas in the European Community the Member States themselves play the double role of participants in the Community decision-making and of antipodes to the legal order of the Community as such."). *Id*. at 262.

[115] Vikram Amar, *Indirect Effects of Direct Election: A Structural Examination of the Seventeenth Amendment*, 49 VAND. L. REV. 1347, 1352 (1996).

[116] *Id.* at 1349. *See generally* ROBERT C. BYRD, THE SENATE 1789-1989 (1988); C.H. HOEBEKE, THE ROAD TO MASS DEMOCRACY, ORIGINAL INTENT AND THE SEVENTEENTH AMENDMENT (1995).

[117] U.S. CONST. amend. XVII, cl. 1. "The Senate of the United States shall be composed of two Senators from each State, elected by the people thereof, for six years; and each Senator shall have one vote." *Id.* Proposals to amend the process had been around since the 1820's. Laura E. Little, *An Excursion into the Uncharted Waters of the Seventeenth Amendment*, 64 TEMPLE L. REV. 629, 636 (1991).

[118] Amar, *supra* note 115, at 1353. He also cites "(3) the dissatisfaction with deadlocks in state legislatures that delayed the filling of vacant senatorial seats; and (4) the feeling that state legislatures were spending too much time on the 'national' matter of senatorial selection, thus leaving local matters unattended." *Id.*

[119] *Id.* at 1349.

Generally, Congress has refrained from exercising its authority under the U.S. Constitution "to enact legislation impinging on state tax power"[120] except in the following three categories:[121] (1) state taxation of federal employees;[122] (2) state taxation of interstate transportation and their employees;[123] and (3) state taxation of natural resources.[124] However, in the last decade, there has been an increase in interference with state tax systems.[125]

The State Taxation of Pension Income Act of 1995 (Source Tax Act) is an example of congressional intrusion on state tax sovereignty with respect to the income taxation of individuals.[126] The Source Tax Act prohibits states from taxing the retirement income and pension distributions of their former residents (i.e., those individuals who

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[120] Hellerstein, *Federal Limitations, supra* note 34, at 431; *see also* McLure & Hellerstein, *supra* note 29, at 722 (providing another listing of examples of legislation restricting states' power).

[121] *See generally* Moore, *supra* note 29; 2 HARTMAN & TROST, *supra* note 3, § 14:1, at 575 n.1. For an example of an exception to this rule, see The Internet Tax Freedom Act (ITFA), which was enacted on October 21, 1998, as part of Public Law 105-277. "The original ITFA imposed a three-year moratorium on taxation of Internet access." William J. Quirk & R. Rhett Shaver, *Does Congress Put Federalism at Risk When It Limits the States' Power to Tax?*, 21 ST. TAX NOTES 649, 653-54 (2001).

[122] *See, e.g.*, Soldiers' and Sailors' Civil Relief Amendments of 1942, ch. 581 § 17, 56 Stat. 777 (codified at 50 U.S.C. App. § 574 (1942)) (providing that members of the armed forces are subject to tax only in their respective states of residence, and not necessarily in the states in which they are stationed).

[123] *See, e.g.*, Airport Development Acceleration Act of 1973 § 7(a), Pub. L. No. 93-44, 87 Stat. 88 (codified in 49 U.S.C. App. § 1513 (1973)) (preempting state and local gross receipts taxes on the sale of commercial air transportation). This law was passed after the Supreme Court validated airline passenger head taxes in Evansville-Vanderburgh Airport Auth. Dist. v. Delta Airlines, 405 U.S. 707 (1972). *See also Congressional Power to Proscribe Certain State Taxes, Miscellaneous Tax Bills – 1991: Hearings on S. 90, S. 150, S. 267, S. 284, S. 649 and S. 913 Before the Subcomm. on Taxation of the Senate Comm. on Finance*, 102d Cong. 289, 291 (1991) (legal memorandum by Johnny Killian, Senior Specialist, American constitutional law, Cong. Res. Serv., Lib. of Cong.) [hereinafter *CRS Memo II*].

[124] Tax Reform Act of 1976, Pub. L. No. 94-455, 90 Stat. 1520 (codified as amended at 15 U.S.C. § 391 (1976)) (forbidding states from imposing taxes on or with respect to the generation or transmission of electricity when such a tax would discriminate against out-of-state manufacturers, producers, wholesalers, retailers and consumers of that electricity). Congress's increased restriction on state taxation was engineered by Arizona senators because of a conflict with New Mexico and Arizona concerning New Mexico's tax on electricity generated within the state. *CRS Memo II, supra* note 123.

[125] *See* Multistate Tax Commission, *Federalism at Risk*, app. c. (2003). For two examples of legislation currently pending before Congress that would interfere with a state's ability to tax, see the Telecommuter Tax Fairness Act of 2005, S. 1097, 109th Cong. (2005) (only allowing a state to tax income earned while physically within the state) and the Economic Development Act of 2005, S. 1066, 109th Cong. (2005) (in certain circumstances allowing tax incentives that would otherwise be barred by the Commerce Clause). *See generally* McLure & Hellerstein, *supra* note 29, for an analysis of three congressional proposals.

To avoid such interference, states can coordinate with each other. For example, currently, 42 states and the District of Columbia are involved in the creation of a Streamlined Sales and Use Tax Agreement that went into effect October 1, 2005. This project includes uniform definitions for key items, state level administration and collection of local taxes, and rules designed to make the sourcing of transactions both uniform and simplified (at http://www.streamlinedsalestax.org). As of October, eighteen states are deemed in compliance with the agreement as either full or associate members. Emily Dagostino, *Streamlining System in Place with Inception of Governing Board*, 38 ST. TAX NOTES 165, 165 (2005).

[126] Act of Jan. 10, 1996, Pub. L. No. 104-95, 109 Stat. 979 (codified at 4 U.S.C. § 114 (1996)). The law became effective for retirement income payments received after December 31, 1995. *See also* Tracy A. Kaye, *Show Me the Money: Congressional Limitations on State Tax Sovereignty*, 35 HARV. J. ON LEGIS. 149, 167 (1998).

moved from the state where they earned the income).[127] The most vociferous proponents of the Source Tax Act were retirees who had moved to states that did not impose an income tax.[128] In their view, nonresidents should not be taxed if they do not currently receive benefits from their tax payments.[129] Of course benefits were received when the income was earned[130] but Congress determined that the same income might be "taxed by multiple jurisdictions if the employee had worked in a number of states."[131] Congress's solution was simple: no taxation of the absent retirees by their former states of residence. The Congressional Budget Office estimated the revenue loss to the states at $70 million annually.[132]

Another congressional intrusion on state tax sovereignty has been with respect to taxation of Internet access. The Internet Tax Freedom Act (ITFA) was originally enacted in 1998.[133] Congress's exercise of its Commerce Clause powers in legislating against

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[127] The statute protects all distributions from qualified plans, including, but not limited to: individual retirement accounts, simplified employee pensions, annuity plans or contracts, eligible deferred compensation plans, and governmental plans. *See* Douglas L. Lindholm et al., *State "Source" Taxation of Retirement Benefits – What's Barred, What's Left*, 84 J. TAX'N 299, 299 (1996). *See also* Brian J. Kopp, *New Federal Statute Bars States from Taxing Pension Income of Nonresidents*, 6 J. MULTISTATE TAX'N 68 (1996). California and fifteen other states were attempting to collect income taxes from their absentee retirees, nonresidents who had earned pensions in their states but were collecting these benefits in different states. Quirk & Shaver, *supra* note 121, at 654.

[128] *State Taxation of Nonresidents' Pension Income: Hearings on H.R. 371, H.R. 394 and H.R. 744 Before the Subcomm. on Commercial and Admin. Law of the House Comm. on the Judiciary*, 104th Cong. 24, 40 (1995) [hereinafter *1995 Pension Hearings*] (prepared statement of William C. Hoffman, President, Retirees to Eliminate State Income Source Tax (RESIST)).

> How can a nation that was formed over the issue of "Taxation without representation" allow this to happen? *Because it was the best kept secret in America!* No one was told about this unfair tax that interferes with our right to travel across our country and live where we choose *without suffering a financial penalty*. It is *unthinkable* for an individual in the United States of America to be controlled by a taxing agency without recourse. More important, how can our great Nation allow Senior Citizens to be treated in this terrible manner.

Id. at 41.

[129] *See* H.R. REP. NO. 104-389, at 3-4 (1995), *reprinted in* 1995 U.S.C.C.A.N. 1006 [hereinafter *Source Tax Report*].

[130] Professor James Smith testified that the "taxation without representation" argument must focus on the time during which the income was earned, the time when the state provided the taxpayer with ample benefits. *See 1995 Pension Hearings, supra* note at 128 (prepared statement of James C. Smith, Professor of Law, Georgia University School of Law).

[131] Quirk & Shaver, *supra* note 121, at 654.

[132] *See Source Tax Report, supra* note 129, at 9. The CBO's estimate of the Source Tax Act clarified that:

> Revenue losses could be higher, however, because of the bill's impact on the taxation of certain types of deferred compensation . . . . States that offer their residents credit for taxes paid to other states on retirement income would realize an increase in tax revenue . . . . The extent to which one state's revenue gain would offset another state's revenue loss depends on whether the taxed non-resident currently lives in a state that offers a tax credit . . . . The net overall cost of the bill to state governments would stem primarily from affected retirees who live in states that do not tax personal income tax or offer such tax credits. Many of these nontaxing states tend to be popular retirement destinations.

Source Tax Report, supra note 129, at 9-10. Note that this CBO estimate is for the bill as reported. The legislation that actually passed would be costlier. *See* Telephone Interview with Theresa A. Gullo, Chief, State & Local Government Cost Unit, Congressional Budget Office (CBO) (Aug. 12, 1997).

[133] Act of Oct. 21, 1998, Pub. L. No. 105- 277, 112 Stat. 2681 (1998).

state and local government interference with interstate commerce on the Internet or related services has cost the states billions in foregone revenues.[134] The ITFA only grandfathered the ten states that were already imposing a tax on Internet access at the time of initial passage.[135] The Act also imposed a three-year moratorium on new or discriminatory state and local taxes on electronic commerce that was extended for two years in November 2001 and expired in 2003.[136]

On December 3, 2004, the President signed the Internet Tax Nondiscrimination Act (ITNA). This Act broadens the definition of Internet access and retroactively extends the moratorium through November 2007.[137] ITNA also redefines "tax on Internet Access" to include any tax on Internet access, "regardless of whether such tax is imposed on a provider of Internet access or a buyer of Internet access and regardless of the terminology used to describe the tax."[138] This broader definition prevents states from taxing DSL, Cable, satellite, or wireless Internet access.[139] The states are asserting that this legislation will cost state and local government billions in lost revenues.[140] The Congressional Budget Office estimates that repealing the grandfather clause could cost states at least $80 million to $120 million per year.[141] This estimate, however, does not consider the amount of revenue lost to the other states that are unable to currently tax the Internet.

The ITNA is the result of fierce lobbying by the telecommunications industry. Verizon Communications, Inc., the U.S. Telecom Association, and CTIA (former Congressman Largent's company) touted the bill as a victory for the industry.[142] Additionally, Senator George Allen (R-VA), who was the lead sponsor of the bill, represents many Internet and technology companies including America Online.

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[134] *See* Quirk & Shaver, *supra* note 121, at 653. "The original ITFA imposed a three-year moratorium on taxation of Internet access. The moratorium generally prevented (1) the taxation of Internet access, (2) multiple and discriminatory taxes on electronic commerce, and (3) the application of federal excise taxes on Internet access." *Id*.

[135] Donald Bruce et al., *Has Internet Access Taxation Affected Internet Use?*, 32 ST. TAX NOTES 519, 520 (2004).

[136] Internet Tax Nondiscrimination Act, Pub. L. No. 107- 75, 115 Stat. 703 (2001).

[137] Act of Dec. 3, 2004, Pub. L. No. 108- 435, 118 Stat. 2615 (2004). [hereinafter ITNA]. *See also* Emily Dagostino, *President Signs Internet Tax Moratorium Extension*, 34 ST. TAX NOTES 708 (2004).

[138] ITNA, *supra* note 137. *See* Bruce et. al., *supra* note 135 (detailing economic study); *see also* McLure & Hellerstein, *supra* note 29, at 730 (describing the case for exempting Internet access by households as weak).

[139] *Cox Internet Tax Moratorium Bill Signed into Law at White House*, ST. NEWS SERV., Dec. 6, 2004. The new law allows states that enacted taxes on Internet access prior to October 1998, to continue to have such authority, except for Wisconsin's tax on the Internet. Telephone Interview with Thad Bingle, Majority Counsel, House Judiciary Committee (Dec. 13, 2004). Wisconsin's tax, which was enacted in 1991, will not be grandfathered after November 1, 2006. Press Release, Congressman James Sensenbrenner, Sensenbrenner Provision Eliminates Internet Taxes for Wisconsin (Nov. 19, 2004) [hereinafter Sensenbrenner Release].

[140] Karen Setze, *U.S. House Votes to Extend Moratorium on Internet Access Taxes Until 2007*, 34 ST. TAX NOTES 564, 564 (2004). Wisconsin alone collected $24.3 million in revenue from its Internet Access tax in 2002. Sensenbrenner Release, *supra* note 139.

[141] CBO Rep. S.150 Internet Tax Nondiscrimination Act (Sept. 9, 2003)

[142] *Passage of Internet Tax Bill Hailed as Victory for Broadband*, TELECOMMUNICATIONS REPORTER, Dec. 15, 2004.

The recent experience of congressional intervention in state tax sovereignty as demonstrated by the Source Tax Act and the Internet Tax Nondiscrimination Act lead me to prefer judicial oversight rather than legislative intervention with respect to the United States when protection from tax discrimination is required. Unfortunately, at this point in American history "the few maintain a disproportionate sway over elected representatives . . . ."[143] Professor Alexander goes on to point out that "[t]he will of the people is not done because of the influence of lobbyists, PACs, and others who control large sums of campaign cash."[144] Unlike the Council of Ministers, Congress does not represent the states and there is increasing temptation to enact legislation that benefits a select constituency at a revenue cost to the states.[145] Congress is causing more harm than good in the name of avoiding tax discrimination and should exercise the legislative restraint it historically had shown to the taxing powers of the states. Direct election of Senators has increased their susceptibility to private interest group pressures and has rendered them unable to play their designated role as guardian of the states' rights and interests.[146]

I am not willing to advocate repeal of the Seventeenth Amendment; however, I do recommend an additional procedural constraint on Congress to ensure less congressional interference with state tax laws. Modeling two of the advisory bodies of the European Union, I recommend the formation of a Committee like the Economic and Social Committee and the Committee of the Regions that must be consulted prior to the passage of any legislation impacting state tax laws. In this case, the Committee would be composed of the Treasurers of the fifty states. A vote on the tax measure would not be allowed until the Committee of Treasurers had the opportunity to study the legislation, opine on the consequences to the states and give its recommendations. Although this proposal is no guarantee that the State Taxation of Pension Income Act of 1995 or the Internet Tax Nondiscrimination Act would not have been enacted anyway, a substantive report from the Committee of Treasurers might have provided cover for those Senators and Representatives who desired to vote against the legislation.

B. The Judicial Branch

The European Court of Justice is comprised of twenty-five judges,[147] each appointed for a renewable six-year term. Eight Advocates General assist the Court.[148]

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[143] Mark C. Alexander, *Campaign Finance Reform: Central Meaning and a New Approach*, 60 WASH. & LEE L. REV. 767, 811 (2003).
[144] *Id.* at 812.
[145] I have previously recommended eliminating the $50 million threshold of the Unfunded Mandates Reform Act (UMRA) for legislation that prohibits states from raising revenue. My hope was that this new procedural hurdle would ensure that the states receive heightened protection in the federal legislative process from congressional intrusion on state tax sovereignty. The threat of a recorded vote on whether to impose an unfunded mandate would provide a meaningful deterrent to such legislation. Kaye, *supra* note 126, at 188.
[146] Amar, *supra* note 115, at 1352.
[147] The Nice Treaty amended EC Treaty Article 221 to create a Grand Chamber of Judges that could customarily be used to avoid the burden of plenary sessions. BERMANN, *supra* note 10, at 32-33 (2d ed. Supp. 2004). The Grand Chamber will initially be composed of thirteen Judges with eleven usually sitting in a proceeding. *Id.*

The Advocate General's role is to "present an independent and impartial Opinion after the parties have concluded their submission and before the Judges begin their deliberations."[149] The Court's duties are multi-faceted, although its fundamental task is to "ensure that in the interpretation and application of this Treaty the law is observed."[150] The Court has jurisdiction to examine the validity of all acts adopted by the Council and the Commission, including regulations, directives, and decisions.[151] Appeals can be brought on the grounds of: lack of competence; misuse of powers; or infringement of an essential procedural requirement, the Treaty of Rome, or any rule of law relating to its application.[152] "[T]he Court gives a single collective judgment signed by all the Judges who took part in the deliberations."[153]

To ensure the uniform interpretation of Community Law, the European Court of Justice will render, at the request of any court or tribunal of a Member State, a legally binding preliminary ruling in a case where any question of Community law arises.[154] These preliminary rulings concern such matters as the interpretation of provisions of the Treaties or of acts of the Community institutions and the examination of the validity of Community legal acts. The Court does not formally rule on the merits of the pending case but rather limits the judgment to the interpretation or validity of the relevant question of Community law.[155] Other national courts can rely on these Article 234 rulings as authoritative interpretations of Community law or may resubmit the question to the Court for a preliminary ruling in the hope that the Court of Justice departs from its

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[148] EC Treaty, *supra* note 15, arts. 221-223.

[149] ANTHONY ARNULL, THE EUROPEAN UNION AND ITS COURT OF JUSTICE 7-8 (1999). The Opinion of the Advocate General outlines relevant facts and legislation, further analyzes the issues raised and relevant case law, and concludes with a recommendation to the Judges. While it is difficult to determine the influence of the Advocate General on the judgments of the Court, most legal scholars believe that the Advocate General's Opinion is helpful in the Judges' decision-making. *Id*. at 8.

[150] EC Treaty, *supra* note 15, art. 220.

[151] EC Treaty, *supra* note 15, art. 230; *see also* art. 249.

[152] EC Treaty, *supra* note 15, art. 230; *see also* LIER ET AL., *supra* note 113, at 19.

[153] ARNULL, *supra* note 149, at 8. *See also* Laurence R. Helfer & Anne-Marie Slaughter, *Toward a Theory of Effective Supranational Adjudication,* 107 YALE L.J. 273, 326 (1997). "[T]he treaty does not prohibit individual opinions; it is the Court itself that has imposed a rule of unanimity." *Id.* at 326 n.230 (citing Rules of Procedure of the Court of Justice, Rule 27.5, 1974 O.J. (L 350) 1, *reprinted in* Encyclopedia of European Community Law at B8108 (1992)). *See generally* David Edward, *How the Court of Justice Works,* 20 EUR. L. REV. 539, 557 (1995) (discussing the advantages and disadvantages of the collegiate approach of the ECJ).

[154] EC Treaty, *supra* note 15, art. 234. Article 234 provides:

> The Court of Justice shall have jurisdiction to give preliminary rulings concerning:
>
> a) the interpretation of this Treaty;
> b) the validity and interpretation of acts of the institutions of the Community and of the ECB;
> c) the interpretation of the statutes of bodies established by an act of the Council, where those statutes so provide.
>
> Where such a question is raised before any court or tribunal of a Member State, that court or tribunal may, if it considers that a decision on the question is necessary to enable it to give judgment, request the Court of Justice to give a ruling thereon.
>
> Where any such question is raised in a case pending before a court or tribunal of a Member State against whose decisions there is no judicial remedy under national law, that court or tribunal shall bring the matter before the Court of Justice.

Id.

[155] LIER ET AL., *supra* note 113, at 20.

previous decision.[156] Thus, unlike the U.S. Supreme Court, the ECJ does not normally rule directly on the validity of Member State laws.[157] However, it often clearly indicates as a matter of law that a Member State's legislation violates the EC Treaty.[158]

Along with referrals under Article 234, the ECJ must also hear cases brought by the Commission pursuant to its obligation to enforce the Treaty.[159] The Commission has stated that it intends to pursue a more proactive strategy in the field of tax infringements and is more willing to initiate action before the Court upon finding incompatible tax provisions.[160] Indeed on February 5, 2003, the Commission started infringement proceedings against Belgium, France, Italy, Portugal, and Spain with respect to the non-deductibility of contributions to pension funds resident in other Member States.[161] All this leads to a far greater proportion of tax cases being heard by the ECJ when compared to the U.S. Supreme Court, which decides very few tax cases.[162]

The ECJ's judgments in the direct tax area have been increasing in number and the implications of these decisions are far-reaching. It is clear that national income tax regimes must be exercised consistently with the Treaty provisions establishing the

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[156] STEPHEN WEATHERILL & PAUL BEAUMONT, EC LAW 157-58 (1993). Since October 31, 1989, the Court of First Instance (CFI) has resolved disputes between the EC and its employees as well as appeals against an EC institution concerning competition matters (i.e., antitrust and merger control). The Treaty of Nice has expanded the CFI's jurisdiction, which is now competent to rule on matters covering a wide range of matters arising under the EC Treaty and in connection with the Community's secondary law. *See* GOEBEL SUPPLEMENT, EUROPEAN UNION LAW, *supra* note 76, at 10.

[157] ARNULL, *supra* note 149, at 50-51. Article 234 does not give the Court jurisdiction "to decide upon the validity of a provision of domestic law in relation to the Treaty . . . ." *Id.* (citing Case 6/64, Costa v. ENEL, 1964 E.C.R. 585, 592-93). "Rather the proceedings take the form of a dialogue in which the two courts seek a solution to the case in hand which is in harmony with the requirements of Community Law." *Id.* at 51.

[158] Bermann, *supra* note 14, at 355.

[159] EC Treaty, *supra* note 15, art. 220. Article 220 states "[t]he Court of Justice shall ensure that in the interpretation and application of this Treaty the law is observed." *Id.*

[160] Tax Policy in the EU, *supra* note 41, at 23. In the direct tax field, progress towards Community objectives cannot be left to chance that a taxpayer will bring a case to the ECJ. *Id.* For example, in 2004, the Commission sent a reasoned opinion, the second stage of infringement proceedings, to Germany because of a "discriminatory" tax on school fees paid to non-German schools. Press Release, European Commission, Commission Requests Germany to End Discrimination Concerning Housing Grants and Tax Deductions (Jan. 7, 2004) (*available at* http://europa.eu.int/rapid/pressReleasesAction.do?reference=IP/04/20). In 2005, the Commission referred Portugal to the ECJ, the final stage of infringement proceedings, because of a "discriminatory" tax on capital gains reinvested in another Member State. Press Release, European Commission, Commission Takes Portugal to Court over Discriminatory Rules on Tax Relief for Capital Gains from Home Sales (Jan. 13, 2005) (*available at* http://europa.eu.int/rapid/pressReleasesAction.do?reference=IP/05/36).

[161] *Six Member States Rapped for Discrimination Against Pension Funds,* EUR. REP., Feb. 8, 2003, *available at* LEXIS No. 2749.

[162] Commission on Structural Alternatives for the Federal Courts of Appeals, Final Report 73 (Dec. 18, 1998), *available at* http://www.library.unt.edu/gpo/csafca/final/appstruc.pdf. Two examples of state tax cases that were denied certiorari are White v. Reynolds Metals Co., 558 So. 2d 373 (Ala. 1989), *cert denied*, GMC v. Dep't of Revenue of Ala., 496 U.S. 912 (1990) (out-of-state corporation claimed disparate treatment between in-state and out-of-state corporations; court held that the Alabama code violated neither the Equal Protection nor the Commerce Clauses) and Colo. Interstate Gas Co. v. Okla. Tax Comm'n, 774 P.2d 468 (Okla. 1989), *cert. denied*, 493 U.S. 854 (1989) (pipeline companies purchasing gas for sale out-of-state objected to Oklahoma's severance tax on the gas, arguing unsuccessfully that it violated the Supremacy, Due Process and Equal Protection Clauses).

fundamental freedoms of the Community.[163] The fundamental freedoms encompass a prohibition of discrimination on the grounds of nationality specifically found in the following articles: Article 39 for the free movement of workers, Article 43 for the freedom of establishment, Article 49 for the freedom of provision of services, and Article 56 for the free movement of capital.[164] Because tax law often distinguishes between resident and nonresident taxpayers and between permanent establishments and subsidiaries, the application of this nondiscrimination principle may result in the incompatibility of national tax provisions with EC law.[165] The Court of Justice has ruled that when such distinctions result in the unequal treatment of individuals or companies from other Member States, the tax law must be struck down unless the Member State can justify a derogation.[166]

III. Principles of International and Interstate Taxation

Most national governments as well as most state governments in the United States employ a set of jurisdictional rules based on the principle of residence-based taxation of residents and source-based taxation of nonresidents.[167] For example, some EU Member States tax residents on their worldwide income but allow them to claim a credit for any foreign taxes paid on their foreign source income in order to prevent double taxation.[168] Other Member States grant an exemption for the foreign source income.[169] All of the states that employ broad-based personal income taxes allow a credit for taxes paid by their residents to other states.[170] Taxpayers' personal and family circumstances are taken

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[163] *See, e.g.*, Case C-279/93, Finanzamt Köln-Altstadt v. Schumacker, 1995 E.C.R. I-225, ¶ 21; *see infra* Part V(B).

[164] *See infra* Part IV(B).

[165] *See infra* Part III.

[166] *See, e.g.*, Case 270/83, Comm'n v. France, 1986 E.C.R. 273 (holding that failure of French law to extend a tax credit granted to French companies for French-source dividends to the permanent establishments of foreign companies constituted a restriction on their freedom of establishment); Case C-330/91, The Queen v. *ex parte* Commerzbank, 1993 E.C.R. I-4017 (holding that a law prohibiting nonresident companies from obtaining interest on tax repayments was incompatible with Articles 52 and 58 of the EC Treaty); Case C-279/93, Finanzamt Köln-Altstadt v. Schumacker, 1995 E.C.R. I-225 (holding that a German law denying nonresident taxpayers special tax deductions allowed residents for family circumstances was incompatible with Article 48 when the nonresident worker receives almost all his income from that Member State). *See also* De Wolf, *supra* note 12, at 127-28.

[167] For a more thorough discussion of the difference between residence-based and source-based taxation, *see* HUGH J. AULT & BRIAN J. ARNOLD, COMPARATIVE INCOME TAXATION: A STRUCTURAL ANALYSIS 347-49, 395-97 (2d ed. 2004). *See also* BRIAN ARNOLD & MICHAEL MCINTYRE, INTERNATIONAL TAX PRIMER 15-26 (2d ed. 2002). "As to residents a state may, and does, exert its taxing power over their income from all sources, whether within or without the State . . . ." Shaffer v. Carter, 252 U.S. 37, 57 (1920).

[168] *See* AULT & ARNOLD, *supra* note 167, at 357-60. Generally, the amount of creditable foreign income taxes is limited to the amount of home country tax otherwise due on the taxpayer's foreign source income. *Id.* at 362-65.

[169] *See id.* at 357-60.

[170] JEROME R. HELLERSTEIN & WALTER HELLERSTEIN, STATE AND LOCAL TAXATION, CASES AND MATERIALS 898 (7th ed. 2001). As of February 2006, 41 states had broad-based personal income taxes.

into account in the State of residence, because residence-based taxation often taxes taxpayers in accordance with their ability to pay.[171] Administratively, this is also logical because the State of residence has all the information necessary to assess the taxpayer's overall ability to pay tax.[172]

In contrast, most EU Member States tax nonresidents on any income derived from sources within the country's borders (subject to treaty restrictions) but do not attempt to tax nonresidents on income derived from sources outside the country's borders.[173] Similarly, a state's power to tax nonresidents "extends only to their property owned within the State and their business, trade, or profession carried on therein, and the tax is only on such income as is derived from those sources."[174] Traditionally, source countries do not allow personal deductions to nonresidents because they are only taxing nonresidents on a portion of their income.[175]

It has been accepted under international tax principles that nonresident taxpayers are in a different situation than resident taxpayers and thus, the taxation of nonresidents can be different than that of resident taxpayers.[176] This creates a conflict between these generally accepted tax principles and the effective prevention of discriminatory treatment of foreign source income.[177] The top statutory personal state income tax rates in the U.S. range from zero to 11%.[178] When compared to the lowest top personal income tax rate in the EU of 19%,[179] it is obvious that the stakes are quite high in the EU. In Part IV, I

See 1 RESEARCH INSTITUTE OF AMERICA, ALL STATES TAX GUIDE ¶ 228 (2005). See *infra* notes 434-463 and accompanying text for a discussion of how business income is allocated in the United States.

[171] "[I]nternational tax law, and in particular the Model Double Taxation Treaty of the Organization for Economic Cooperation and Development (OECD), recognizes that in principle, the overall taxation of taxpayers, taking account of their personal and family circumstances, is a matter for the State of residence." Case C-279/93, Finanzamt Köln-Altstadt v. Schumacker, 1995 E.C.R. I-225, ¶ 32.

[172] Michael J. McIntyre & Richard D. Pomp, *State Income Tax Treatment of Residents and Nonresidents Under the Privileges and Immunities Clause*, 13 ST. TAX NOTES 245, 248 (1997). Professor van Raad points out that the Member States could verify the data required for computing personal deductions and the amount of income derived from sources abroad by using the EC 1977 Directive Concerning Mutual Assistance by the Competent Authorities but acknowledges that the administrative burden would be relatively great. Kees van Raad, *Fractional Taxation of Multi-State Income of EU Resident Individuals – A Proposal, in* 27 SERIES ON INTERNATIONAL TAXATION, LIBER AMICORUM SVEN-OLOF LODIN, 211, 220 (Krister Andersson et al. eds., 2001).

[173] *See* AULT & ARNOLD, *supra* note 167, at 357-60. However, some Member States using an "exemption with progression" approach, apply a tax rate based on worldwide income but only with respect to the includible income. *Id.* at 372-74.

[174] Shaffer v. Carter, 25 U.S. 37, 57 (1920)*; see also* HELLERSTEIN & HELLERSTEIN, *supra* note 170, at 368-69.

[175] McIntyre & Pomp, *supra* note 172, at 248; *see also* J.S. Phillips & M.H. Collins, *The General Report*, LXXa CAHIERS DE DROIT FISCAL INTERNATIONAL 15, 52-53 (1985).

[176] TERRA & WATTEL, *supra* note 51, at 45-46; see *also* ROY ROHATGI, BASIC INTERNATIONAL TAXATION 132-33 (2002).

[177] Wattel, *supra* note 52, at 224-26.

[178] As of February 2006, nine states had no broad-based personal income taxes. *See* RESEARCH INSTITUTE OF AMERICA, *supra* note 170, at ¶ 228.

[179] As of May 2006, the top statutory personal income tax rate in the EU is 59%. Press Release, European Commission, New report on Taxation in the EU from 1995 to 2004, tbl., (May 17, 2006), *available at* http://europa.eu.int/rapid/pressReleasesAction.do?reference=STAT/06/62&format=HTML&aged=0&language=EN&guiLanguage=en.

outline how the Supreme Court and the European Court of Justice each have struggled with this problem.

IV. Judicial Limitations on Tax Sovereignty

A. Judicial Limitations on State Tax Sovereignty in the United States

The "capacity of state and local taxation to burden national markets has long been recognized" in the United States.[180] The protectionist tariffs that the states were levying upon each other were "one of the chief motives for the Constitutional Convention in 1787."[181] The Constitution incorporated the fourth of the Articles of Confederation,[182] albeit in a briefer form, and its goal of eradicating state sponsored discrimination against nonresidents.[183] In fact, there are three provisions of the U.S. Constitution that an individual taxpayer may utilize to challenge an allegedly discriminatory state tax:[184] the

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[180] DANIEL SHAVIRO, FEDERALISM IN TAXATION: THE CASE FOR GREATER UNIFORMITY 6 (1993).

[181] *Id.* (citing THE FEDERALIST NO. 7 (Alexander Hamilton), NO. 42 (James Madison)).

[182] ART. OF CONF. art. IV. Article IV states:

> The better to secure and perpetuate mutual friendship and intercourse among the people of the different States in this Union, the free inhabitants of each of these States, paupers, vagabonds, and fugitives from justice excepted, shall be entitled to all privileges and immunities of the free citizens in the several States; and the people of each State shall have free ingress and egress to and from any other State and shall enjoy therein all the privileges of trade and commerce, subject to the same duties, impositions, and restrictions as the inhabitants thereof respectively, provided that such restrictions shall not extend so far as to prevent the removal of property imported into any State, to any other State, of which the owner is an inhabitant; provided also that no imposition, duties or restrictions shall be laid by any State, on the property of the United States, or either of them.

Id.

[183] *See* TRIBE, *supra* note 44, § 6-36, at 1251 n.4. "Article IV, § 2, is a shortened version of the Privileges and Immunities Clause of art. IV of the Articles of Confederation. Persuaded that art. IV, § 2 of the proposed Constitution was 'formed exactly upon the principles of the 4th article of the present Confederation . . . ,' the Constitutional Convention adopted the Privileges and Immunities Clause with little discussion." *Id*. (citing 3 THE RECORDS OF THE FEDERAL CONVENTION, *supra* note 2, at 112; 2 *id*. at 173, 187, 443). The Commerce Clause and Privileges and Immunities Clause both have their sources in the fourth Article of the Articles of Confederation. Baldwin v. Fish & Game Comm'n of Mont., 436 U.S. 371, 379 (1977).

[184] The Fourteenth Amendment to the Constitution contains a Privileges *or* Immunities Clause which provides that "[n]o State shall make or enforce any law which shall abridge the privileges or immunities of citizens of the United States." U.S. CONST. amend. XIV, § 1. The framers of the Fourteenth Amendment used the Article IV clause as a model for the amendment. TRIBE, *supra* note 44, § 7-2, at 1299. Their intention was to "nationalize individual rights" by incorporating "not only those rights specifically secured by the first eight amendments, but also those declared in the original Constitution . . . ." *Id.* at 1301-02. However, five years after the Amendment was adopted, the Supreme Court held in the *Slaughter House Cases,* 83 U.S. (16 Wall.) 36 (1873) that the provision created no new rights of national citizenship, but merely furnished an additional guarantee of rights, which citizens of the United States already possessed.

Privileges and Immunities Clause of Article IV;[185] the Equal Protection Clause;[186] and the Commerce Clause.[187] The Privileges and Immunities Clause is inapplicable to corporations,[188] but they may assert either the Equal Protection Clause[189] or the Commerce Clause.[190]

1. The Privileges and Immunities Clause

The U.S. Constitution explicitly limits a state's power to discriminate against residents of the other states with the Privileges and Immunities Clause.[191] Article IV bans state discrimination against citizens of other states by providing that "[t]he Citizens of each State shall be entitled to all Privileges and Immunities of Citizens in the several

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Id. Justice Miller's narrow construction of the Clause reduced it to "a vain and idle enactment, which accomplished nothing, and most unnecessarily excited Congress and the people on its passage." *Id.* at 96 (Field, J., dissenting). It is therefore "viewed by many commentators as a 'dead letter for tax purposes.'" 1 RICHARD D. POMP & OLIVER OLDMAN, STATE AND LOCAL TAXATION 4-2 (4th ed. 2001) (citing PAUL J. HARTMAN, FEDERAL LIMITATIONS ON STATE AND LOCAL TAXATION 162, 165 (1st ed. 1981)).

[185] U.S. CONST. art. IV, § 2, cl. 1 [hereinafter Privileges and Immunities Clause]. *See, e.g.*, Toomer v. Witsell, 334 U.S. 385 (1948) (striking down a licensing fee on nonresident shrimp boat owners at a rate 100 times greater than resident owners because the state failed to demonstrate a unique link between the state's conservation interests and the discriminatory fee measures and thus violated the Privileges and Immunities Clause).

[186] U.S. CONST. amend. XIV, § 1 [hereinafter Equal Protection Clause]. The Equal Protection Clause of the Fourteenth Amendment states "[n]o State shall . . . deny to any person within its jurisdiction the equal protection of the laws." *Id.*

[187] Commerce Clause, *supra* note 28. The Commerce Clause of the United States Constitution grants Congress the power "[t]o regulate Commerce with foreign Nations, and among the several States, and with the Indian Tribes." *Id.*

[188] *See* Bank of Augusta v. Earle, 38 U.S. (13 Pet.) 519, 586 (1839) (holding that the protections of the Privileges and Immunities Clause do not extend to corporations). *See also* W. & S. Life Ins. Co. v. State Bd. of Equalization, 451 U.S. 648, 656 (1981) (citing Hemphill v. Orloff, 277 U.S. 537, 548-50 (1928)) (noting that the Privileges and Immunities Clause does not protect corporations); Blake v. McClung, 172 U.S. 239 (1898); Paul v. Virginia, 75 U.S. (8 Wall.) 168, 177-78 (1868).

[189] *See, e.g.*, Wheeling Steel Corp. v. Glander, 337 U.S. 562 (1949) (holding Ohio's ad valorem tax against intangible property of foreign corporations, whom the state chose to domesticate, constituted unequal treatment of corporations in violation of the Equal Protection Clause). *See infra* notes 226-240 and accompanying text.

[190] *See, e.g.*, Complete Auto Transit, Inc. v. Brady, 430 U.S. 274, 278 (1977) (upholding a Mississippi tax on the "privilege of doing business" thus unanimously rejecting the rule that this type of state tax is per se unconstitutional). *See infra* notes 264-283 and accompanying text.

[191] When analyzing a state's statutory scheme under this Clause, the Supreme Court has held that the terms "citizen" and "resident" are basically interchangeable. *See* Travis v. Yale & Towne Mfg. Co., 252 U.S. 60, 78-79 (1920). The Court discussed the terms "citizen" and "resident" stating:

> [A] general taxing scheme . . . if it discriminates against all non-residents, has the necessary effect of including in the discrimination those who are citizens of other States; and, if there be no reasonable ground for the diversity of treatment, it abridges the privileges and immunities to which such citizens are entitled.

Id. at 79. "The Court has held that in determining whether a person is a citizen of a state, residency in the state is synonymous with state citizenship." ERWIN CHEMERINSKY, CONSTITUTIONAL LAW: PRINCIPLES AND POLICIES 446 n.5 (2d ed. 2002) (citing United Bldg. & Constr. Trades Council v. Mayor of Camden, 465 U.S. 208, 216 (1984)).

States."[192] Justice Blackmun wrote, "[t]he [Privileges and Immunities] Clause has been a necessary limitation on state autonomy not simply because of the self-interest of individual states, but because state parochialism is likely to go unchecked by state political processes when those who are disadvantaged are by definition disenfranchised as well."[193] The Clause remedies this breakdown in the representative process by requiring state residents to bear the same burden that they choose to place on outsiders "constitutionally tying the fate of outsiders to those possessing political power, the framers insured that their interests would be well looked after."[194]

In 1920, the Supreme Court had to decide whether a state had the right to tax any part of a nonresident's income when an Illinois resident challenged Oklahoma's power to tax him on more than a million and a half dollars from his Oklahoma oil business holdings.[195] As long as the taxes on nonresidents were not "more onerous in effect" than the taxes imposed on similarly situated residents, the Court held that Oklahoma could tax nonresidents on income earned within the state.[196] The appellant claimed a further violation of the Privileges and Immunities and Equal Protection Clauses because the Oklahoma statute denied nonresidents a deduction for losses except those incurred within the state.[197] The Court held that there was no obligation to allow a deduction for losses elsewhere incurred as the tax on nonresidents was only on income derived from sources within the state.[198]

The *Travis* case, decided the same day, held that the Privileges and Immunities Clause prohibited the complete denial of personal exemptions to nonresidents even though New York law provided a corresponding credit against New York taxes if they paid resident income taxes in a State that allowed such a credit to New York residents.[199] The denial of the exemption was also not justified by

> the theory that non-residents have untaxed income derived from sources in their home States or elsewhere . . . corresponding to the amount upon which residents of that State are exempt from taxation . . . [because] the discrimination is not conditioned upon the existence of such untaxed income; and it would be rash to assume that non-residents taxable in New York under this law, as a class, are receiving additional income from outside sources equivalent to the amount of the exemptions that are accorded to citizens of New York and denied to them.[200]

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[192] Privileges and Immunities Clause, *supra* note 185. *See generally* Douglas Laycock, *Equal Citizens of Equal and Territorial States: The Constitutional Foundations of Choice of Law*, 92 COLUM. L. REV. 249, 261-66 (1992)

[193] *Camden*, 465 U.S. at 230 (Blackmun, J., dissenting). "Citizens of sister states are outsiders, subject to in-group/out-group bias, denied the right to vote, which is the key to power in the political process, and thus dependent on judicial protection." Laycock, *supra* note 192, at 267.

[194] *Camden*, 465 U.S. at 230-31 (Blackmun, J., dissenting) (citing J. ELY, DEMOCRACY AND DISTRUST 83 (1983)).

[195] Shaffer v. Carter, 252 U.S. 37, 49 (1920).

[196] *Id.* at 52-53.

[197] *Id.* at 57.

[198] *Id.*

[199] Travis v. Yale & Towne Mfg. Co., 252 U.S. 60, 80-81 (1920).

[200] *Id.* at 81.

Unfortunately, the *Travis* case left many unanswered questions regarding the implementation of this rule.[201]

Subsequent courts have had difficulties interpreting both the *Shaffer* and *Travis* decisions, resulting in confused and inconsistent decisions regarding the allowance of exemptions, deductions, and credits to nonresidents.[202] Thus, when the *Lunding* case[203] presented itself, commentators noted that the "high court's prior income tax rulings . . . offer no clear standards to apply to constitutional challenges to state taxes and have generally been closely decided."[204]

Toomer v. Witsell[205] marks the beginning of our modern understanding of the Privileges and Immunities Clause.[206] The Supreme Court shifted its focus of review from categorizing fundamental rights of citizenship to analyzing the state's justifications for the discrimination.[207] Thirty years later, the Supreme Court muddied the waters with their decision in *Baldwin v. Montana Fish and Game Commission.*[208] Although the *Toomer* Court had invalidated a commercial licensing fee that was 100% greater for nonresidents, the *Baldwin* Court upheld an elk-hunting fee that was 25% greater for nonresidents holding that the Privileges and Immunities Clause protects only "basic and essential activities."[209] Thus, the *Baldwin* Court did not feel compelled to apply the "substantial reason test" of *Toomer*.[210] This limitation of the Privileges and Immunities

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[201] *See* Walter Hellerstein, *Some Reflections on the State Taxation of a Nonresident's Personal Income,* 72 MICH. L. REV. 1309, 1342 (1974).

[202] *Id. See, e.g.*, Goodwin v. State Tax Comm'r, 146 N.Y.S.2d 172 (N.Y. App. Div. 1955), *aff'd*, 133 N.E.2d 711 (N.Y. 1956), *cert. denied,* 352 U.S. 805 (1956) (holding as constitutional a New York statute that denied a New Jersey resident, who derived all of his income from New York, any deductions such as real estate taxes and mortgage interest paid in connection with his residence in New Jersey); Berry v. State Tax Comm'n, 397 P.2d 780 (Or. 1964) (holding that a statute that restricted deductions unless connected to income arising from sources within Oregon was not a denial of the privileges and immunities of citizenship because the clause did not preclude disparity of treatment when there are independent reasons for it). *But see* Spencer v. S.C. Tax Comm'n, 316 S.E.2d 386 (S.C. 1985), *aff'd*, 471 U.S. 82 (1985) (holding that a statute that denied personal deductions to nonresidents violated the Privileges and Immunities Clause); Wood v. Dep't of Revenue, 749 P.2d 1169 (Or. 1988) (holding that an Oregon statute that denied a deduction for alimony to nonresidents violated the Privileges and Immunities Clause). *See also* James Michael Dailey, Case Note and Comment, *The Thin Line Between Acceptable Disparate Tax Treatment of Nonresidents and Unconstitutional Discrimination Under the Article IV Privileges and Immunities Clause:* Lunding v. N.Y. Tax App. Trib., *118 S. Ct. 766 (1998)*, 21 HAMLINE L. REV. 563, 580-86 (1998).

[203] Lunding v. N.Y. Tax App. Trib., 522 U.S. 287 (1998) (holding that New York State's denial of a tax deduction for alimony payments made by nonresidents while allowing such deduction for residents violated the Privileges and Immunities Clause). *See also infra* notes 434-463.

[204] Marcia Coyle, *Justices Eye Deductibility of Alimony: At Issue is a State's Power to Tax Nonresidents Differently,* NAT'L L.J., Nov. 17, 1997, at B1.

[205] 334 U.S. 385 (1948).

[206] TRIBE, *supra* note 44, § 6-36, at 1250.

[207] *Id.* § 6-37, at 1256.

[208] 436 U.S. 371 (1978).

[209] *Id.* at 387. *See also* TRIBE, *supra* note 44, § 6-37, at 1257. The dissent, Justice Brennan joined by Justices Marshall and White, argued that it is irrelevant whether a given right is deemed fundamental. "[T]he time has come to confirm explicitly that which has been implicit in our modern . . . decisions, namely that an inquiry into whether a given right is 'fundamental' has no place in our analysis of whether a State's discrimination against nonresidents . . . violates the Clause. Rather, our primary concern is the State's justification for its discrimination." Baldwin v. Fish & Game Comm'n of Mont., 436 U.S. 371, 402 (1977) (Brennan, J., dissenting). *See also* ROTUNDA & NOWAK, *supra* note 43, § 12.7, at 255 (3d ed. 1999).

[210] TRIBE, *supra* note 44, § 6-37, at 1257.

Clause to "fundamental" rights is rarely invoked[211] and the freedom from discriminatory taxation had previously been named as a fundamental right.[212]

The *Toomer* case had established the "substantial reason" test when the Supreme Court decided that the Privileges and Immunities Clause would not preclude nonresident discrimination where there were valid independent reasons for such treatment.[213] Thus,

> [l]ike many other constitutional provisions, the privileges and immunities clause is not an absolute. It does bar discrimination against citizens of other States where there is *no substantial reason for the discrimination beyond the mere fact that they are citizens of other States.* But it does not preclude disparity of treatment in the many situations where there are perfectly valid independent reasons for it.[214]

Because South Carolina was unable to prove that "non-citizens constitute a peculiar source of evil at which the statute is aimed,"[215] the state's discriminatory licensing fee was struck down.[216] The state also failed to demonstrate a sufficient link between "the legitimate interests served and the discrimination practiced"[217] and that less restrictive alternatives were impractical.[218]

The Supreme Court applied this test in *Austin v. New Hampshire*.[219] New Hampshire imposed a commuter income tax on nonresidents' New Hampshire source income that exceeded $2,000.[220] The tax rate was 4% unless the nonresident taxpayer's State of residence imposed a lesser rate of tax had the income been earned in that State.[221] Although New Hampshire residents were also taxed on their out-of state income, the statute excluded various categories of income such that no resident was actually taxed

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[211] Laycock, *supra* note 192, at 265.
[212] Gary J. Simson, *Discrimination Against Nonresidents and the Privileges and Immunities Clause of Article IV,* 128 U. PA. L. REV. 379 (1979) (citing Corfield v. Coryell, 6 F. Cas. 546, 551 (C.C.E.D. Pa. 1823) (No. 3230)).
[213] TRIBE, *supra* note 44, § 6-37, at 1256. The substantial reason test replaced the reasonableness exception that the Supreme Court had carved out in the late nineteenth and early twentieth century. *Id.* at 1254 (citing Blake v. McClung, 172 U.S. 239, 256 (1898)).
[214] Toomer v. Witsell, 334 U.S. 385, 396 (1948) (emphasis added). "The State is not without power . . . to restrict the type of equipment used . . . to graduate license fees according to the size of the boat, or even to charge non-residents a different fee which would merely compensate the State for any added enforcement burden . . . ." *Id.* at 398-99 (citations omitted). *See, e.g.,* Carlson v. State, 798 P.2d 1269 (Alaska 1990) (fee differentials between residents and nonresidents for commercial fishing licenses did not violate the Privileges and Immunities Clause if the differential equalized the financial burden of fisheries management between residents and nonresidents). *See also* Sarah H. Davis, Carlson v. State *and the Privileges and Immunities Clause: The Alaska Wrinkle in Nonresident Fishing Fee Differentials*, 21 ALASKA L. REV. 91 (2004) (discussing Carlson's three trips to the Alaska Supreme Court).
[215] *Toomer*, 334 U.S. at 398.
[216] TRIBE, *supra* note 44, § 6-37, at 1256.
[217] *Id.* "Nothing in the record indicates that non-residents use larger boats or different fishing methods than residents, or that any substantial amount of the State's general funds is devoted to shrimp conservation." *Toomer*, 334 U.S. at 398.
[218] TRIBE, *supra* note 44, § 6-37, at 1256.
[219] 420 U.S. 656 (1975).
[220] *Id.* at 657-58.
[221] *Id.* at 658. In such a case, the New Hampshire tax would be reduced to the amount of the tax that the State of residence would have imposed. *Id*.

on his out-of-state income.[222] Given the "rule of substantial equality of treatment" for resident and nonresident taxpayers, the Supreme Court found the commuter tax unconstitutional because the tax fell exclusively on the income of nonresidents.[223] New Hampshire argued that the tax was not more burdensome once the tax credit the commuters received from their State of residence was taken into account.[224] The majority replied that "the constitutionality of one State's statutes affecting nonresidents [cannot] depend upon the present configuration of the statutes of another State."[225]

2. The Equal Protection Clause

Although the Privileges and Immunities Clause is inapplicable to corporations,[226] the Equal Protection Clause, which also forbids states to discriminate against outsiders in favor of locals, has been used to prohibit discrimination against corporations.[227] The Fourteenth Amendment, ratified in 1868, decrees "[n]o State shall . . . deny to any person within its jurisdiction the equal protection of the laws."[228] The Clause does not, however, prohibit the states from making reasonable classifications among such persons.[229] The

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[222] *Id.* at 658-59. As the Court explained:

> The Commuters Income Tax initially imposes a tax of 4% as well on the income earned by New Hampshire residents outside the State. It then exempts such income from the tax, however: (1) if it is taxed by the State from which it is derived; (2) if it is exempted from taxation by the State from which it is derived; or (3) if the State from which it is derived does not tax such income.

Id. at 658.

[223] *Id.* at 665. Note, however, that the Supreme Court has thus far refused to answer whether taxing "telecommuting" is similarly unconstitutional. Huckaby v. N.Y. State Div. of Tax App., 829 N.E.2d 276 (N.Y. 2005), *cert. denied*, 2005 U.S. LEXIS 7864 (Oct. 31, 2005). In *Huckaby*, the high court of New York ruled that a tax on a Tennessee resident working for a New York company from his home in Tennessee does not violate the Constitution. *Id.* at 284.

[224] *Austin*, 420 U.S. at 665-66.

[225] *Id.* at 668.

[226] *See* Bank of Augusta v. Earle, 38 U.S. (13 Pet.) 519, 586 (1839) (holding that the protections of the Privileges and Immunities Clause do not extend to corporations). *See also* W. & S. Life Ins. Co. v. State Bd. of Equalization, 451 U.S. 648, 656 (1981) (citing Hemphill v. Orloff, 277 U.S. 537, 548-50 (1928)) (noting that the Privileges and Immunities Clause does not protect corporations); Blake v. McClung, 172 U.S. 239 (1898); Paul v. Virginia, 75 U.S. (8 Wall.) 168, 177-78 (1868).

[227] Hellerstein, *supra* note 201, at 1332 n.104. *See also* Metro. Life Ins. Co. v. Ward, 470 U.S. 869 (1985) (invalidating Alabama statute that taxed out-of-state insurance companies at a higher rate than domestic companies because the state's purposes were not legitimate to pass the Equal Protection rational basis test); WHYY, Inc. v. Borough of Glassboro, 393 U.S. 117 (1968) (holding that a state cannot deny a tax exemption to a foreign corporation, allowed to enter a state to do business, that a domestic corporation would receive); Wheeling Steel Corp. v. Glander, 337 U.S. 562 (1949) (holding that where a state has permitted a foreign corporation to enter and transact business equal protection must be accorded at least to the extent that their property is entitled to an equally favorable ad valorem tax basis).

[228] Equal Protection Clause, *supra* note 186. The Supreme Court ruled that a corporation is a 'person' within the meaning of the Fourteenth Amendment in *Santa Clara County v. Southern Pacific Railroad,* 118 U.S. 394 (1886).

[229] *See* Lehnhausen v. Lake Shore Auto Parts Co., 410 U.S. 356, 359-60 (1973) (holding that an Illinois constitutional amendment authorizing ad valorem taxes on personal property of corporations and similar entities but not with respect to personal property of individuals did not violate the Equal Protection Clause because it was not the result of invidious discrimination and was within the state's discretion to make classifications for tax purposes). *See also* Allied Stores of Ohio v. Bowers, 358 U.S. 522, 526-27 (1959)

statute will be upheld as long as there is a plausible policy reason for the classification,[230] plausible legislative facts on which a rational legislator could rely,[231] and "the relationship of the classification to its goal is not so attenuated as to render the distinction arbitrary or irrational."[232] Specifically, the Court found in *Nordlinger* that California could differentiate between existing landowners and new owners with respect to the property tax. The state's interest in preserving neighborhoods by allowing existing owners to rely on certain tax rates so as to discourage constant turnover of land was legitimate.[233] "[U]nless a classification warrants some form of heightened review because it jeopardizes exercise of a fundamental right or categorizes on the basis of an inherently suspect characteristic, the Equal Protection Clause requires only that the classification rationally further a legitimate state interest."[234]

The Supreme Court has rarely invalidated state tax laws solely on the basis that they violate the Equal Protection Clause.[235] Legislatures have been given broad latitude in the classifications and distinctions created by tax statutes.[236] One exception to this deference exists with respect to interstate business and classifications involving residency usually taking the form of a "domestic preference tax."[237] Thus in *Southern Railway*, the Supreme Court invalidated an Alabama statute that imposed a higher ad valorem property tax on railroads not chartered in the state on the grounds that no legitimate reason was proffered for favoring local companies over nonresidents.[238] Legitimate state interest does not include a state favoring "its own residents by taxing foreign corporations at a higher rate solely because of their residence . . . ."[239] This "constitutes the very sort of parochial discrimination that the Equal Protection Clause was intended to prevent."[240]

(holding that an Ohio statute imposing an ad valorem tax on property stored by local companies while exempting out-of-state owners of warehouses did not deny domestic corporations the equal protection of the law).

[230] Nordlinger v. Hahn, 505 U.S. 1, 11 (1992) (*citing* U.S. R.R. Ret. Bd. v. Fritz, 449 U.S. 166, 174, 179 (1980)).

[231] *Id.* (Minnesota v. Clover Leaf Creamery Co., 449 U.S. 456, 464 (1981)).

[232] *Id.* (citing Cleburne v. Cleburne Living Ctr., Inc., 473 U.S. 432, 446 (1985)).

[233] *Id.* at 12-13. The Court found California's property tax scheme to be constitutional even though it created dramatic disparities. *Id.*; *see also* Leo P. Martinez, *The Trouble with Taxes: Fairness, Tax Policy, and the Constitution,* 34 HASTINGS CONSTITUTIONAL L. QUARTERLY 413 (2005). Ms. Nordlinger, for example, paid approximately the same taxes on a $170,000 home as her neighbor paid on a Malibu beach front home worth $2.1 million. *Nordlinger*, 505 U.S. at 6-7.

[234] *Id.* at 10.

[235] Matthew Zinn & Steve Reed, *Equal Protection and State Taxation of Interstate Business,* 41 TAX LAW. 83, 92 (1987).

[236] Regan v. Taxation with Representation of Washington, 461 U.S. 540, 547 (1983). *See also* Madden v. Kentucky, 309 U.S. 83, 88 (1940) (noting that legislatures have the greatest freedom with respect to classifications in the tax area).

[237] Zinn & Reed, *supra* note 235, at 92.

[238] Southern R.R. Co. v. Greene, 216 U.S. 400, 417-18 (1910).

[239] Metro. Life Ins. Co. v. Ward, 470 U.S. 869, 878 (1985) (invalidating Alabama statute that taxed out-of-state insurance companies at a higher rate than domestic companies because the state's purposes were not legitimate to pass the equal protection rational basis test). Insurance corporations in particular utilize the Equal Protection Clause because the McCarran-Ferguson Act exempts insurance corporations from Commerce Clause restraints. HELLERSTEIN & HELLERSTEIN, *supra* note 170, at 64-65. However, this use of the Equal Protection Clause has been characterized as disingenuous: "This newly unveiled power of the Equal Protection Clause would come as a surprise to the Congress that passed the McCarran-Ferguson Act .

3. The Dormant Commerce Clause

Discrimination against sister-state corporations has most often been analyzed using the dormant Commerce Clause.[241] Implicitly, the Commerce Clause prohibits state discrimination of interstate commerce as well as undue burdens on commerce.[242] The Commerce Clause embodies the "principle that our economic unit is the Nation . . . ."[243] Although the principal source of judicial doctrine limiting state taxation of interstate commerce, the Court did not espouse this proposition until the late nineteenth century.[244] In 1827, Justice Marshall had indicated in dictum that a state tax measure could interfere with interstate commerce and would be treated like state regulatory measures found to infringe upon the national commerce power.[245] It was not until the *Case of the State Freight Tax*[246] that the Supreme Court explicitly established "the doctrine that the Commerce Clause by its own force limits [a] state['s] tax[ing] power over interstate commerce.[247] The U.S. Supreme Court held that a Pennsylvania levy on all freight transported in the state was unconstitutional because it was "in effect a regulation of

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. . . In the McCarran-Ferguson Act, Congress expressly sanctioned such economic parochialism in the context of state regulation and taxation of insurance." *Ward*, 470 U.S. at 900-01 (O'Connor, J., dissenting).

[240] *Ward*, 470 U.S. at 878.

[241] David Schmudde, *Constitutional Limitations on State and Local Taxation of Nonresident Citizens*, 1999 MICH. ST. L. SCH. L. REV. 95, 119. *See also* Christopher R. Drahozal, *Preserving the American Common Market: State and Local Governments in the United States Supreme Court,* 7 SUP. CT. ECON. REV. 233 (1999).

[242] *See* Mark Tushnet, *Rethinking the Dormant Commerce Clause,* 1979 WISC. L. REV. 125, 130-31.

[243] *Id.* (quoting H.P. Hood & Sons v. DuMond, 336 U.S. 525, 539 (1949) ("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 . . . .")).

[244] Hellerstein, *Federal Limitations, supra* note 34, at 433 n.24. The evolution of the early Commerce Clause doctrine has been outlined numerous times. *See, e.g.,* JUSTICE FELIX FRANKFURTER, THE COMMERCE CLAUSE UNDER MARSHALL, TANEY AND WAITE 18-19 (1937); F. RIBBLE, STATE AND NATIONAL POWER OVER COMMERCE (1937); John B. Sholley, *The Negative Implications of the Commerce Clause,* 3 U. CHI. L. REV. 556 (1936).

[245] Hellerstein, *Federal Limitations, supra* note 34, at 434 (citing Brown v. Maryland, 25 U.S. (12 Wheat.) 419, 448-49 (1827)). Justice Marshall wrote:

> [T]he taxing power of the States must have some limits . . . . It cannot interfere with any regulation of commerce. If the States may tax all persons and property found on their territory, what shall restrain them from taxing goods in their transit through the State from one port to another . . . or from taxing the transportation of articles passing from the State itself to another State, for commercial purposes? These cases are all within the sovereign power of taxation, but would obviously derange the measures of Congress to regulate commerce, and affect materially the purpose for which it was given.

Id.

[246] Reading R.R. Co. v. Pennsylvania, 82 U.S. (15 Wall.) 232 (1873). Two companion cases were decided in 1873 that bore the same name. Thus, they were distinguished in the reports as *Case of the State Freight Tax & State Tax on Railway Gross Receipts,* 82 U.S. (15 Wall.) 284 (1873). Both cases were cited for the proposition that "a state tax on any activity or process of interstate commerce was an invalid regulation of commerce." William Lockhart, *A Revolution in State Taxation of Commerce?,* 65 MINN. L. REV. 1025, 1027 (1981).

[247] Hellerstein, *Federal Limitations, supra* note 34, at 435.

interstate commerce."[248] This rule that a state may not directly tax interstate commerce became known as the "Formal Rule."[249]

From its origin in 1873 until 1977, this "Formal Rule" was one of the primary bases for invalidating state taxes that affected commerce.[250] Using this rule, the Supreme Court found unconstitutional state taxes such as a gross receipts tax, a sales tax, and a license tax on interstate sales.[251] Other grounds for invalidation included discrimination against interstate commerce, the risk of multiple taxation, unfair apportionment, and the absence of due process jurisdiction.[252] However, the "Formal Rule" was severely criticized because taxes found to have only an indirect burden on interstate commerce were upheld even though the distinction was arbitrary and unpredictable.[253] In *Complete Auto*,[254] the Supreme Court abandoned this historical approach and replaced it with a more functional test that focused on the purpose and effect of the tax, using a four-part test to determine whether the Commerce Clause has been violated.[255]

Modern Commerce Clause doctrine forbids nearly all discrimination on the basis of economic factors from sister-states.[256] Discrimination against interstate commerce is "virtually per se invalid"[257] or has been subject to the "strictest scrutiny."[258] In *Boston Stock Exchange*, the Supreme Court stated: "No State, consistent with the Commerce Clause, may impose a tax which discriminates against interstate commerce . . . by providing a direct commercial advantage to local business.[259] Professor Tribe has said that "[t]he states may still serve as laboratories for democracy, but their fiscal experiments are subject to rigorous judicial scrutiny, designed to smoke out measures that discriminate."[260]

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[248] *Reading R.R. Co.*, 82 U.S. (15 Wall.) at 279.

[249] *See* CHEMERINSKY, *supra* note 191, at 434. "The thrust of the Formal Rule was that a state may not impose a tax on any activity or process viewed by the Court as part of interstate commerce." Howard Hunter, *Federalism and State Taxation of Multistate Enterprises,* 32 EMORY L. J. 89, 96 (1983).

[250] Lockhart, *supra* note 246, at 1029.

[251] CHEMERINSKY, *supra* note 191, at 434 (citing Freeman v. Hewit, 329 U.S. 249 (1946); McLeod v. J.E. Dilworth Co., 322 U.S. 327 (1944); Mills v. Portland, 268 U.S. 325 (1925), respectively).

[252] Lockhart, *supra* note 246, at 1029. This chapter will only focus on discrimination of interstate commerce as the basis for invalidating a state tax.

[253] CHEMERINSKY, *supra* note 191, at 434 (citing U. S. Glue Co. v. Oak Creek, 247 U.S. 321 (1918); McGoldrick v. Berwind-White Coal Min. Co., 309 U.S. 33 (1940)).

[254] Complete Auto Transit, Inc. v. Brady, 430 U.S. 274 (1977) (upholding a Mississippi tax on the "privilege of doing business" thus unanimously rejecting the rule that this type of state tax is per se unconstitutional). *See* Lockhart, *supra* note 246, at 1026.

[255] CHEMERINSKY, *supra* note 191, at 435. *See infra* notes 264-266 and accompanying text.

[256] Laycock, *supra* note 192, at 269. *See also* Schmudde, *supra* note 241, at 119.

[257] Fulton Corp. v. Faulkner, 516 U.S. 325, 331 (1996) (quoting Oregon Waste Systems, Inc. v. Dep't of Envtl. Quality of Ore., 511 U.S. 93, 99 (1994)) (holding that North Carolina intangibles tax is unconstitutional because the amount of the tax was inversely proportionate to the corporation's liability for North Carolina income tax). *See* CHEMERINSKY, *supra* note 191, at 440.

[258] *See* Chem. Waste Mgmt., Inc. v. Hunt, 504 U.S. 334, 342-43 (1992) (quoting Hughes v. Oklahoma, 441 U.S. 322, 337 (1979)) (noting that "facial discrimination invokes the strictest scrutiny of any purported legitimate local purpose . . . .").

[259] Boston Stock Exch. v. State Tax Comm'n, 429 U.S. 318, 329 (1977). *See also* CHEMERINSKY, *supra* note 191, at 440.

[260] TRIBE, *supra* note 44, § 6-16, at 1113.

However, the Supreme Court has on occasion exercised "an extra dose of judicial sympathy for state taxing power."[261] The Court grants greater deference to state and local taxation autonomy than to Commerce Clause cases involving regulation.[262] Professor Shaviro notes:

> The Supreme Court may treat tax cases as meriting greater deference to state and local governments than regulation cases because it regards the power to tax as at the heart of a government's sovereignty. Another explanation is that the court simply lacks confidence in its ability to understand tax cases and resolve them intelligently, and thus prefers to let most challenged taxes stand.[263]

Under the test spelled out in dicta in *Complete Auto,*[264] a tax on interstate commerce must meet four requirements if seeking to survive constitutionality under the Commerce Clause:[265] 1) the activity must be sufficiently connected to the state to justify a tax; 2) the tax must be fairly apportioned; 3) the tax must not discriminate against interstate commerce; and 4) the tax must be fairly related to benefits provided to the taxpayer.[266] The third prong of this test, the ban on discrimination against interstate commerce, is the predominant basis upon which the Supreme Court has struck down state taxes in recent years.[267]

A tax law is discriminatory if it "tax[es] a transaction or incident more heavily when it crosses state lines than when it occurs entirely within the State."[268] The Supreme Court will also strike down state taxes that are facially neutral, but have a disproportionate impact on nonresidents.[269] For example, in *West Lynn Creamery, Inc. v. Healy,* a Massachusetts tax on all milk dealers was held unconstitutional.[270] The impact of this tax was identical to that of a discriminatory tax because the revenues from the tax were used to subsidize in-state dairy farmers.[271] In *American Trucking Associations, Inc.*, a flat tax on trucks for Pennsylvania road use violated the Commerce Clause because the effect was to impose a higher burden on a multistate company than on an in-

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[261] LAURENCE H. TRIBE, AMERICAN CONSTITUTIONAL LAW, § 6-15, at 442 (2d ed. 1988).
[262] *See id. See also* Edmund W. Kitch, *Regulation and the American Common Market, in* REGULATION, FEDERALISM, AND INTERSTATE COMMERCE 9, 31 (A. Dan Tarlock ed., 1981).
[263] Daniel Shaviro, *An Economic and Political Look at Federalism in Taxation,* 90 MICH. L. REV. 895, 942 (1992) (citing Richard Briffault and Henry Monaghan, respectively).
[264] 430 U.S. 274 (1977). In a unanimous decision, the Supreme Court upheld the constitutionality of a Mississippi tax on gross revenues for the privilege of doing business in that state. The Court stated that the taxpayer did "not allege that its activity which Mississippi taxes does not have a sufficient nexus with the State; or that the tax discriminates against interstate commerce; or that the tax is unfairly apportioned; or that it is unrelated to services provided by the State." *Id.* at 277-78 (citations omitted). *See also* CHEMERINSKY, *supra* note 191, at 435.
[265] *See* POMP & OLDMAN, *supra* note 184, at 1-21.
[266] Complete Auto Transit, Inc. v. Brady, 430 U.S. 274, 279 (1977).
[267] TRIBE, *supra* note 44, § 6-16, at 1107.
[268] Chem. Waste Mgmt., Inc. v. Hunt, 504 U.S. 334, 342 (1992) (quoting Armco Inc. v. Hardesty, 467 U.S. 638, 642 (1984)).
[269] CHEMERINSKY, *supra* note 191, at 442.
[270] *Id.* (citing 512 U.S. 186 (1994)).
[271] *Id.*

state company.[272] "If each State imposed flat taxes for the privilege of making commercial entrances into its territory, there is no conceivable doubt that commerce among the States would be deterred."[273]

Unfortunately, commentators are unanimous in their criticism of Privileges and Immunities,[274] Equal Protection,[275] and Commerce Clause[276] jurisprudence as it relates to constitutional scrutiny of state tax laws.[277] In 1977, the Supreme Court itself observed again that its judicial application of constitutional principles to the multitude of state tax cases left "much room for controversy and confusion and little in the way of precise guides to the States in the exercise of their indispensable power of taxation."[278] Professor Stark has described the whole field as having "a sort of wild west quality to it."[279] Although the *Complete Auto* decision has generally received favorable comments from scholars,[280] there are doubts about the ability of judges to undertake the complex inquiries seemingly compelled by the case.[281] Some scholars believe that the test is more complicated than necessary, "primarily because several of its parts are functionally

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[272] Am. Trucking Ass'ns, Inc. v. Scheiner, 483 U.S. 266 (1987). *See also* Walter Hellerstein, *Is "Internal Consistency" Foolish? Reflections on an Emerging Commerce Clause Restraint on State Taxation*, 87 MICH. L. REV. 138, 164 (1988) (noting that such flat taxes effectively discriminate against interstate commerce in that they "bear more heavily on the interstate than the intrastate enterprise merely because the former does business across state lines.").

[273] *Am. Trucking Ass'ns, Inc.*, 483 U.S. at 284.

[274] *See generally* Jon David Pheils, *Defining the Scope of the Article Four Privileges and Immunities Clause,* 54 U. CIN. L. REV. 883 (1986); David Schultz, *State Taxation of Interstate Commuters: Constitutional Doctrine in Search of Empirical Analysis,* 16 TOURO L. REV. 435 (2000).

[275] *See* Zinn & Reed, *supra* note 235, at 99-102 (arguing the Court applies two different standards in tax cases); George F. Carpinello, *State Protective Legislation and Nonresident Corporations: The Privileges and Immunities Clause as a Treaty of Nondiscrimination,* 73 IOWA L. REV. 351, 408 (1988) (arguing that the Court refuses to invalidate state protectionist measures under a test greater than rational basis).

[276] *See generally* David Shores, *State Taxation of Interstate Commerce—Quiet Revolution or Much Ado About Nothing?,* 38 TAX L. REV. 127, 129 (1982); Edward A. Zelinsky, *Restoring Politics to the Commerce Clause: The Case for Abandoning the Dormant Commerce Clause Prohibition on Discriminatory Taxation,* 29 OHIO N. L. REV. 29 (2002).

[277] *See* Hellerstein, *State Taxation, supra* note 33, at 44; *see also* Dailey, *supra* note 202, at 563.

[278] Boston Stock Exch. v. State Tax Comm'n, 429 U.S. 318, 329 (1977) (quoting Nw. States Portland Cement Co. v. Minnesota, 358 U.S. 450, 457 (1959)). *See also* Hellerstein, *Federal Limitations, supra* note 34, at 441. "Supreme Court decisions concerning commerce clause limitations on state taxing power have long been characterized by meaningless distinctions, encrusted rules, and a lack of principled analysis." Shores, *supra* note 276, at 129.

[279] As Professor Stark explains,

> The 'problem' here (if one considers it that) is that the only institutional regulator is the U.S. Supreme Court, which only periodically hears state tax cases. And when it does hear such cases, it is pulled in too many directions to regulate this field effectively. It wants to prevent states from 'overreaching' while also preventing taxpayer abuses while also respecting state [sovereignty] while also not prescribing rules that are too detailed (since the Constitution, after all, says CONGRESS gets to regulate interstate commerce, not the Supreme Court). As a result, this whole field has a sort of wild west quality to it.

Posting of Professor Kirk Stark, stark@law.ucla.edu to TAXPROF@LISTSERV.UC.EDU (June 23, 2002) (copy on file with author).

[280] LAURENCE H. TRIBE, AMERICAN CONSTITUTIONAL LAW § 6-15, at 442 (2d ed. 1988). Lockhart, *supra* note 246, at 1026-27.

[281] For a pessimistic analysis of the *Complete Auto* decision, *see generally* Shores, *supra* note 276, at 129 (suggesting that "the Court has failed to lay the groundwork for a coherent method of analysis.").

redundant."[282] There is also the fear that the Supreme Court will apply the *Complete Auto* test just as mechanically as it applied the Formal Rule. [283]

With respect to the Privileges and Immunities Clause, the Supreme Court has consistently refused to develop bright-line rules preferring instead to analyze each case on an ad hoc factual basis.[284] In tracing the evolution of equal protection in cases involving the taxation of nonresident corporations, commentators have noted that the Court has vacillated between "rigorous and virtually nonexistent review."[285] Scholars have also noted that an inherent weakness in equal protection analysis is choosing the proper level of generality to examine.[286]

B. Judicial Limitations on Member State Tax Sovereignty in the European Union

The objective of the Treaty of Rome was to create a single common market that would increase the volume and the gain from trade between the Member States.[287] To create such a market, the EEC Treaty contemplated the removal of obstacles to the free movement of goods, persons, services, and capital between the Member States.[288] Primarily, the removal of obstacles to free movement is based on the principle of equal treatment similar to the Equal Protection Clause of the U.S. Constitution. This principle is enshrined in the general prohibition of discrimination on the grounds of nationality found in Article 12 of the EC Treaty.[289] Article 12 provides: "Within the scope of application of this Treaty, and without prejudice to any special provisions contained therein, any discrimination on grounds of nationality shall be prohibited."[290]

However, because of the "special provisions" governing the free movement of goods,[291] persons,[292] services,[293] and capital,[294] Article 12 has rarely been applied independently.[295] Instead, the ECJ has interpreted the "Four Freedoms" as having direct

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[282] Jesse H. Choper & Tung Yin, *State Taxation and the Dormant Commerce Clause: The Object-Measure Approach*, 1998 SUP. CT. REV. 193.
[283] Hunter, *supra* note 250, at 95.
[284] The Supreme Court has failed to develop a bright line test or guiding interpretation for the Privileges and Immunities Clause but instead applies a narrow analysis on a case-by-case basis. Dailey, *supra* note 202, at 565. *See also* Christopher H. Lunding, *U.S. Supreme Court Finds New York's Resident-Only Alimony Deduction Unconstitutional,* 8 J. MULTISTATE TAX'N 52 (1998); Phiels, *supra* note 274.
[285] Zinn & Reed, *supra* note 235, at 92.
[286] POMP & OLDMAN, *supra* note 184, at 2-35.
[287] EEC Treaty, *supra* note 4, art. 2 (now art. 2).
[288] EEC Treaty, *supra* note 4, art. 3(c) (now art. 3(1)(c)).
[289] *See* PAUL FARMER & RICHARD LYAL, EC TAX LAW 310 (1994); *see also* Eileen O'Grady, *World Tax Conference Comes to London*, 26 TAX NOTES INT'L 1058 (2002).
[290] EC Treaty, *supra* note 15, art. 12.
[291] EC Treaty, *supra* note 15, arts. 28, 29.
[292] EC Treaty, *supra* note 15, art. 39.
[293] EC Treaty, *supra* note 15, art. 49.
[294] EC Treaty, *supra* note 15, art. 56.
[295] TERRA & WATTEL, *supra* note 51, at 23. The only situations where Article 12 has been applied independently are those in which there is no specific prohibition of discrimination in the EC Treaty. *Id.* (citing Case 305/87, Comm'n v. Hellenic Republic, 1989 E.C.R. 1461; Case C-1/93, Halliburton Servs. BV v. Staatssecretaris van Financiën, 1994 E.C.R. I-1137; Case C-311/97, Royal Bank of Scotland plc v. Elliniko Dimosio (Greek State), 1999 E.C.R. I-2651).

applicability,[296] meaning that economic operators can invoke these rights before national courts and challenge the validity of domestic legislation.[297] Thus, it is now clear that Treaty provisions, because they have been adopted by the Member States as part of their basic constitutional charter, take precedence over all forms of domestic law including tax law.[298] This distinguishes the EC Treaty from other international treaties such as NAFTA and GATS where income taxation has been excluded from their coverage.[299] Although, in the absence of harmonization, competence for direct taxation falls to the Member States, well-established case law holds these Treaty provisions applicable in the field of direct taxation.[300] Member States must apply Community law and refrain from applying those provisions of their national law that are incompatible with the EC Treaty.[301]

The Commission began challenging Member States' tax laws by instituting infringement proceedings pursuant to Article 226,[302] starting with the *Newspaper Publishers* case of 1985.[303] It was only a matter of time before private parties decided to test the compatibility of national income tax provisions against their "constitutional rights."[304] The first case regarding the individual income tax concerned a Luxembourg law that denied any repayment of tax to a part-year resident.[305] Mr. Biehl, a German national, resided and worked in the Grand Duchy of Luxembourg until October 1983.[306] His employer over withheld income tax but when Mr. Biehl filed for a repayment, the tax office denied his request.[307] Mr. Biehl successfully argued that the law was covertly discriminatory because it mainly applied to taxpayers who were not Luxembourg nationals.[308]

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[296] Case 26/62, Van Gend en Loos v. Nederlandse Administratie Der Belastingen, 1963 E.C.R. 1, ¶ 12.
[297] VAN THIEL, *supra* note 20, at 5; *see also* TERRA & WATTEL, *supra* note 51, at 30.
[298] VAN THIEL, FREE MOVEMENT OF PERSONS, *supra* note 10, at 22. Professor van Thiel concludes that there is "no convincing theoretical or jurisprudence-based argument to support either the strict or the moderate sovereignty exception" for the income tax laws and treaties of the Member States. *Id*. He points out that the Court has rejected the strict sovereignty exception in its income tax case law either implicitly or explicitly. *Id.* at 23-24.
[299] *Id.* at 21.
[300] Study on Analysis of Potential Competition and Discrimination Issues Relating to a Pilot Project for an EU Tax Consolidation Scheme for the European Company Statute (Societas Europaea), *available at* http://europa.eu.int/comm/taxation_customs/resources/documents/report_deloitte.pdf. Reprinted at 2004 WTD 186-8, 11 n.36 [hereinafter Deloitte EU Study].
[301] VAN THIEL, FREE MOVEMENT OF PERSONS, *supra* note 10, at 19.
[302] The Commission may bring an action against a Member State for failing to fulfill its obligations under the Treaty. EC Treaty, *supra* note 15, art. 226. *See also supra* notes 41 and 159 and accompanying text.
[303] Case 18/84, Comm'n v. French Republic (Newspaper Publishers Case), 1985 E.C.R. I-1339 (holding that a French tax law that denied certain tax benefits to newspaper publishers for publications printed in other Member States violated Article 30 of the EEC Treaty).
[304] VAN THIEL, FREE MOVEMENT OF PERSONS, *supra* note 10, at 20. *See also* Stein, *supra* note 1, at 901. "From its inception, the Court of Justice has construed the European Economic Community Treaty in a constitutional mode rather than employing the international law methodology of treaty interpretation." *Id*.
[305] Case C-175/88, Biehl v. Admin. des Contributions, 1990 E.C.R. I-1779, ¶ 5.
[306] *Id.* ¶ 3.
[307] *Id.* ¶¶ 4-6.
[308] *Id.* ¶ 7. The ECJ held that the Luxembourg law violated Article 48 (now Art. 39) with respect to the free movement of workers. *Id.* ¶ 19.

Settled case-law requires equal treatment under the EC Treaty and prohibits not only overt discrimination based on nationality[309] but also all covert forms of discrimination that lead to the same result.[310] "[C]riteria such as . . . residence of a worker, may according to circumstances, be tantamount, as regards their practical effect, to discrimination on grounds of nationality . . . ."[311] Covert discrimination is defined broadly enough by the Court to include a wide range of restrictive rules such as residence, language and qualification requirements.[312] These rules are considered discriminatory unless they serve a legitimate purpose and are proportionate.[313] In its judgments, the Court has continually explained that although direct taxation falls within the competence of the Member States, they must nonetheless exercise that competence consistently with Community law and avoid any discrimination on grounds of nationality.[314]

Furthermore, the Four Freedoms also prohibit restrictions in the country of origin. In *Baars*, the Netherlands refused to grant the same tax exemption from the wealth tax to residents who manage a company resident in a Member State other than the Netherlands, while granting that advantage to residents with a substantial holding in a company resident in the Netherlands.[315] The ECJ found that this difference in the treatment of taxpayers was contrary to Article 52 (now Art. 43) of the Treaty.[316]

1. The Free Movement of Goods

The free movement of goods, the most important Treaty Freedom for achieving a customs union,[317] provided the legal basis for one of the earliest tax cases, the *Newspaper Publishers* case.[318] The free movement of goods articles provide for a total prohibition of customs duties or their equivalent[319] as well as the prohibition of quantitative restrictions

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[309] *See, e.g.*, Case C-330/91, The Queen v. Inland Revenue Comm'rs, *ex parte* Commerzbank AG, 1993 E.C.R. I-4017.

[310] Case C-175/88, Biehl v. Admin. des Contributions, 1990 E.C.R. I-1779, ¶ 19 (citing Case 152/73, Sotgiu v. Deutsche Bundespost, 1974 E.C.R. 153, ¶ 11). *See also* Armand de Mestral & Jan Winter, *Mobility Rights in the European Union and Canada*, 46 MCGILL L. J. 979, 999 (2001) (citing Case 15/69, Wurttembergische Milchverwertung-Sudmilch-AG v. Ugliola, 1969 E.C.R. 363).

[311] Case 152/73, Sotgiu v. Deutsche Bundespost, 1974 E.C.R. 153, ¶ 11.

[312] Paul Farmer, *The Court's Case Law on Taxation: A Castle Built on Shifting Sands?*, 12 EC TAX REV. 75, 76 (2003).

[313] *Id. See, e.g.*, Case C-237/94, O'Flynn v. Adjudication Officer, 1996 E.C.R. I-2617.

[314] "Although, as Community law stands at present, direct taxation does not as such fall within the purview of the Community, the powers 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 (citing Case C-246/89, Comm'n v. United Kingdom, 1991 E.C.R. I-4585, ¶ 12). *See also* Case C-80/94, Wielockx v. Inspecteur der Directe Belastingen, 1995 E.C.R. I-2493, ¶ 16; Case C-311/97, Royal Bank of Scotland plc v. Elliniko Dimosio (Greek State), 1999 E.C.R. I-2651, ¶ 19.

[315] Case C-251/98, Baars v. Inspecteur der Belastingen Particulieren/Ondernemingen Gorinchem, 2000 E.C.R. I-2787, ¶ 30.

[316] *Id.* ¶ 31.

[317] Bermann, *supra* note 14, at 355. "The relevant Treaty provisions (Articles 30 through 37) basically require the Member States to refrain from enacting or maintaining unjustifiable trade-impeding restrictions. By attributing direct effect to these provisions, the Court enabled - in fact directed - national courts to deny legal effect to Member State measures containing such restrictions." *Id.*

[318] Case 18/84, Comm'n v. French Republic (Newspaper Publishers Case), 1985 E.C.R. I-1339.

[319] EC Treaty, *supra* note 15, arts. 23-27.

on imports and all measures having equivalent effect.[320] The second prohibition forbids any trading rules enacted by Member States that "are capable of hindering, directly or indirectly, actually or potentially, intra-Community trade."[321] This "negation of impermissible restraints on interstate trade of course powerfully echoes the Supreme Court's dormant commerce clause jurisprudence."[322]

In the *Newspaper Publishers* case, French tax law provided for special reserves or deductions for the acquisition of equipment or buildings used in the publication of newspapers devoted to politics.[323] However, publishing houses could not benefit from these special tax provisions if the printing was done outside of France.[324] The Court held that because this tax provision caused French publishing houses to print in France rather than abroad, this tax measure obstructed intra-Community trade.[325] As the French Government provided no reasonable justification for the tax provision, it was prohibited for having an equivalent effect to that of a quantitative import restriction.[326]

2. The Free Movement of Persons

Although the citizens of the European Union do not have a general right of residence across the Union comparable to that of U.S. citizens with respect to the states,[327] they may move and reside freely within the EU subject to limitations and conditions set forth in Article 18 of the EC Treaty.[328] Article 39 protects the free movement of workers.[329] As early as 1968, the Council laid down the requirement in Article 7 of Regulation No. 1612/68 that workers who are nationals of a Member State

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[320] EC Treaty, *supra* note 15, arts. 28-31.
[321] Case 8/74, Procureur du Roi v. Dassonville, 1974 E.C.R. 837, ¶ 5.
[322] Bermann, *supra* note 14, at 355.
[323] Case 18/84, Comm'n v. French Republic (Newspaper Publishers Case), 1985 E.C.R. I-1339 ¶ 2.
[324] *Id.* ¶ 3.
[325] *Id.* ¶ 16.
[326] *Id.* ¶¶ 15-16. See *infra* notes 385-395 and accompanying text regarding justifications.
[327] Although not explicitly referred to in the U.S. Constitution, it is understood that the Constitution guarantees a right to travel. United States v. Guest, 383 U.S. 745, 757 (1966). Justice Jackson stated that it "is a privilege of citizenship of the United States, protected from State abridgment, to enter any State of the Union either for temporary sojourn or for the establishment of permanent residence therein . . . ." Edwards v. California, 314 U.S. 160, 183 (1941) (Jackson, J., concurring). *See also* A.P. van der Mei, *Freedom of Movement for Indigents: A Comparative Analysis of American Constitutional Law and European Community Law*, 19 ARIZ. J. INT'L & COMP. L. 803, 810 (2002).
[328] de Mestral & Winter, *supra* note 310, at 1003; EC Treaty, *supra* note 15, art. 18. Article 18 provides:

> 1. Every citizen of the Union shall have the right to move and reside freely within the territory of the Member States, subject to the limitations and conditions laid down in this Treaty and by the measures adopted to give it effect.
> 2. The Council may adopt provisions with a view to facilitating the exercise of the rights referred to in paragraph 1; save as otherwise provided in this Treaty, the Council shall act in accordance with the procedure referred to in Article 251. The Council shall act unanimously throughout this procedure.

Id.
[329] van der Mei, *supra* note 327, at 830 n.129; EC Treaty, *supra* note 15, art. 39. Article 39 states: "1. Freedom of movement for workers shall be secured within the Community. 2. Such freedom of movement shall entail the abolition of any discrimination based on nationality between workers of the Member States as regards employment, remuneration and other conditions of work and employment." *Id.*

are to enjoy, in the territory of another Member State, the same tax benefits as nationals working there.[330]

This nondiscrimination principle is also embodied in Article 43 of the EC Treaty that deals with discriminatory restrictions on the free movement of self-employed persons and the freedom of establishment.[331] The concept of the right of establishment is very broad and allows a Community national to participate in the economic life of another Member State.[332] The prohibition on restrictions on establishment applies to permanent establishments of foreign enterprises as well as subsidiaries of foreign corporations.[333] Unlike the U.S. Constitution,[334] the EC Treaty dictates that companies or firms formed in accordance with the laws of a Member State and that have their registered office, central administration or principal place of business within the Community must be treated in the same way as natural persons who are nationals of Member States.[335] Thus, foreign branches or subsidiaries have brought many direct tax cases before the ECJ.[336] The same analysis that applies to workers has been used to decide these cases.[337]

The ECJ has struck down numerous discriminatory tax regimes that affect residents and nonresidents relying on both Articles 39 and 43 of the EC Treaty. In one of the earliest direct taxation cases to reach the Court (known as the *Avoir Fiscal* case), the Commission instituted infringement proceedings against France pursuant to Article 226.[338] France had an imputation system for the taxation of distributed company profits. Because French tax law granted imputation credits (avoir fiscal) only to resident shareholders, the French branches of German insurers were denied the credit.[339] If the German insurers had invested by locally incorporating subsidiaries in France, these French residents would have been eligible for avoir fiscal.[340] The Court held that this was not a legitimate reason to justify denial of the credit to the branches because such a

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[330] Council Regulation 1612/68, art. 7, 1968 O.J. (L 257) 2, ¶¶ 1, 2. Article 7 of Regulation 1612/68 provides: "1. A worker who is a national of a Member State may not, in the territory of another Member State, be treated differently from national workers by reason of his nationality . . . 2. He shall enjoy the same social and tax advantages as national workers." *Id.*

[331] EC Treaty, *supra* note 15, art. 43. "Freedom of establishment shall include the right to take up and pursue activities as self-employed persons and to set up and manage undertakings . . . ." *Id.*

[332] Deloitte EU Study, *supra* note 300, at 14 n.38.

[333] Paul Farmer, *EC Law and Direct Taxation – Some Thoughts on Recent Issues*, 1 EC TAX J. 91, 92-93 (1997) [hereinafter Farmer, *Direct Taxation*].

[334] The Privileges and Immunities Clause provides no protection for corporations, because corporations are not "citizens." HELLERSTEIN & HELLERSTEIN, *supra* note 170, at 85. *See also supra* notes 226, 241-267 and accompanying text.

[335] EC Treaty, *supra* note 15, art. 48. Although individual citizens are not required to live in a Member State in order to receive these protections, corporations must have a primary establishment within the EU. Deloitte EU Study, *supra* note 300, at 15.

[336] *See, e.g.*, Case C-141/99, Algemene Maatschappij voor Investering en Dienstverlening NV v. Belgische Staat, 2000 E.C.R. I-11619 (AMID); Case C-330/91, The Queen v. Inland Revenue Comm'rs, *ex parte* Commerzbank AG, 1993 E.C.R. I-4017; Case C-264/96, Imperial Chem. Indus. plc v. Colmer (Her Majesty's Inspector of Taxes), 1998 E.C.R. I-4695 (ICI).

[337] Case C-107/94, Asscher v. Staatsecretaris van Financien, 1996 E.C.R. I-3089, ¶ 29 (citing Case C-106/91, Ramrath v. Ministre de la Justice, 1992 E.C.R. I-3351, ¶ 17) (stating that Articles 48 and 52 (now Arts. 39 and 48) are based on the same principles with respect to the prohibition of all discrimination on the grounds of nationality).

[338] Case 270/83, Comm'n v. French Republic, 1986 E.C.R. 273 (Avoir Fiscal).

[339] *Id.* ¶ 4-6.

[340] *Id.* ¶ 10.

holding would coerce foreign investors into incorporating subsidiaries.[341] Article 52 (now Art. 43) expressly allows foreign investors the right to choose the legal form they deem appropriate for operating in another Member State.[342] France was discriminating on the grounds of nationality, as it is understood that the location of the registered office of a company is equivalent to its nationality.[343]

3. The Freedom to Provide Services

Article 49 provides that "restrictions on freedom to provide services within the Community shall be prohibited . . . ."[344] This nondiscrimination rule applies to the taxation of the service provider as well as to the taxation of foreign investors.[345] Further, the ECJ has acknowledged that an investor may invoke Article 49 when a tax law restricts a nonresident company seeking capital[346] as well as a service recipient on behalf of a service provider.[347]

For example, in a dispute between a Finnish national and the Taxation Verification Committee, Ms. Lindman had won 1,000,000 SEK in a Swedish lottery.[348] The winning amount was taxable income according to the Finnish government[349] whereas an exemption would have applied if the lottery had been organized in Finland.[350] After losing her administrative appeals, Ms. Lindman finally appealed to the Administrative Court of the Åland Islands in Finland.[351] This Finnish Court referred the following question to the ECJ for a preliminary ruling: "Does Article 49 EC preclude a Member State from applying rules under which winnings from lotteries held in other Member States are regarded as taxable income of the winner chargeable to income tax, whereas winnings from lotteries held in the Member State in question are exempt from tax?"[352]

The ECJ held the Finnish tax law was discriminatory because it was clear that foreign lotteries are treated differently for tax purposes from, and are in a disadvantageous position compared to, Finnish lotteries.[353] Thus, the ECJ ruled that Article 49 forbids one Member State from charging a different tax rate on lotteries conducted in a foreign state because the difference in taxation entails discrimination.[354] The Finnish Government attempted to justify the discriminatory national legislation by citing "overriding reasons in the public interest such as the prevention of wrongdoing and fraud, the reduction of social damage caused by gaming, the financing of activities in the

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[341] *Id.* ¶ 22.
[342] *Id.*
[343] Richard Lyal, *Non-discrimination and Direct Tax in Community Law*, 12 EC TAX REV. 68, 69 (2003).
[344] EC Treaty, *supra* note 15, art. 49.
[345] Farmer, *Direct Taxation*, *supra* note 333, at 92-93.
[346] Deloitte EU Study, *supra* note 300, at 13 n.66.
[347] *Id.* at 18 n.65.
[348] Case C-42/02, Lindman v. Skatterattelsnamnden, 2003 E.C.R. I-13519, ¶ 7.
[349] *Id.* ¶ 8.
[350] *Id.* ¶ 5.
[351] *Id.* ¶ 9.
[352] *Id.* ¶ 12.
[353] *Id.* ¶ 21.
[354] *Id.* ¶ 27.

public interest and ensuring legal certainty."[355] The Court found that there was no evidence "of a particular causal relationship between such risks and participation by nationals of the Member State concerned in lotteries organised in other Member States."[356]

4. The Free Movement of Capital

Article 56 provides that: "all restrictions on the movement of capital between Member States . . . shall be prohibited . . . ."[357] Article 58 allows Member States to apply national tax law provisions that "distinguish between taxpayers who are not in the same situation with regard to their place of residence or with regard to the place where their capital is invested."[358] However, this exception applies only to laws that were in force on December 31, 1993.[359] Member States are also allowed to take measures to prevent the violation of tax laws in particular[360] but not as "a means of arbitrary discrimination or a disguised restriction on the free movement of capital and payments . . . ."[361]

In *Manninen,* a Finnish national held shares of a Swedish company quoted on the Stockholm Stock Exchange.[362] Under Finnish tax law, dividends were taxed at the rate of 29% as were the corporate profits of companies established in Finland.[363] Finnish shareholders of Finnish companies were entitled to a tax credit that effectively reduced the income tax on dividends from Finnish companies to zero in order to avoid the double taxation of corporate profits.[364] Mr. Manninen was taxed at 29% on the distributions received from the Swedish company and was denied use of the tax credit that would have been available had the dividends been received from a Finnish company.[365]

After the Central Tax Commission held that Mr. Manninen was not entitled to any tax credits with respect to dividends from a Swedish Company,[366] he appealed the decision to the Supreme Administrative Court of Finland.[367] This national court asked the ECJ for a preliminary ruling as to whether Articles 56 and 58, with respect to the free movement of capital, preclude a corporate tax credit system that only allows credits for dividends received from domestic companies.[368]

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[355] *Id*. ¶ 23.
[356] *Id*. ¶ 26.
[357] EC Treaty, *supra* note 15, art. 56(1). Note that this Article is drafted as a restriction prohibition rather than solely being aimed at discriminatory measures. Kristina Stahl, *Free Movement of Capital Between Member States and Third Countries*, 13 EC TAX REV. 47, 47 (2004).
[358] EC Treaty, *supra* note 15, art. 58(1)(a).
[359] Deloitte EU Study, *supra* note 300, at 16. *See also* Declaration No. 7*, annexed to* EC Treaty, *supra* note 15, art. 58(1)(a) (ex art. 73d) ("The Conference affirms that the right of Member States to apply the relevant provisions of their tax law as referred to in Article 58(1)(a) of this Treaty will apply only with respect to the relevant provisions which exist at the end of 1993.").
[360] EC Treaty, *supra* note 15, art. 58(1)(b).
[361] EC Treaty, *supra* note 15, art. 58(3).
[362] Case C-319/02, Manninen, 2004 E.C.R. I-7477, ¶ 12.
[363] *Id.* ¶¶ 6-8.
[364] *Id.* ¶¶ 8-9.
[365] *Id.* ¶¶ 10, 13.
[366] *Id.* ¶ 15.
[367] *Id.* ¶ 16.
[368] *Id.* ¶¶ 17-18.

There is a risk of double taxation of company profits regardless of whether the company distributes the dividend to a shareholder residing in the same Member State or to a shareholder in another Member State.[369] Thus, the ECJ reasoned that the Finnish law had the impact of deterring residents of Finland from investing in foreign companies and constituted an obstacle to the raising of capital in Finland for companies established in other Member States.[370] Finding no justification,[371] the ECJ ultimately ruled that the law amounted to a restriction on the free movement of capital within the meaning of Article 56.[372]

5. Conclusion

The European Court of Justice's case law on direct taxation is part of a much larger body of case law that has evolved over the last twenty years on nondiscrimination and the fundamental freedoms.[373] Unlike U.S. constitutional jurisprudence,[374] the constitutional analysis in ECJ direct tax cases does not differ from other areas of the law.[375] A tax disadvantage is just another obstacle that can confront individuals and businesses that seek to exercise the freedoms that are guaranteed by the Treaty.[376] Due to the political sensitivity of taxation, however, "there was initially a tentative approach" that ended around 1993.[377]

In the beginning, allegations of violations of the free movement of goods were the most prevalent and thus the case law in this area was the most developed. The case law on goods has gone beyond a strict discrimination-based approach and includes examining nondiscriminatory restrictions on the free movement of goods.[378] This broader interpretation has also been followed in cases reviewing violations of the free movement of persons, services and capital.[379] The language used by the ECJ is often inconsistent, in some cases because the wording of the actual Treaty provisions differs.[380] Note that

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[369] *Id.* ¶ 35; *see also* Case C-319/02, Manninen, 2004 E.C.R. I-7477, Op. ¶ 44.
[370] Case C-319/02, Manninen, 2004 E.C.R. I-7477, ¶¶ 22-23 (citing Case C-35/98, Verkooijen, 2000 E.C.R. I-4071, ¶ 35; Case C-334/02 Comm'n v. France, 2004 E.C.R. I-2229, ¶ 24).
[371] *Id.* ¶¶ 48-49, 54.
[372] *Id.* ¶ 55.
[373] Farmer, *supra* note 312, at 75.
[374] "[T]he Court has long subjected taxation to other limits and has long treated taxation differently from other kinds of regulation." TRIBE, *supra* note 44, § 6-15, at 1105. *See also* CHEMERINSKY, *supra* note 191, at 434 ("[T]he topic of state taxation of interstate commerce requires separate consideration because the Court, both historically and currently, has formulated distinct tests for evaluating state taxes that burden interstate commerce.").
[375] "[T]he Court of Justice has declined to erect a barrier around tax law, and vigorously maintains its insistence that here, as elsewhere, Member States must exercise their powers consistently with the fundamental principles of Community law." Paul Stanley, Annotation, *Case C-107/94, Asscher v. Staatsecretaris van Financiën*, 34 C.M.L. REV. 713 (1997).
[376] Lyal, *supra* note 343, at 68.
[377] *Id.*
[378] FARMER & LYAL, *supra* note 289, at 310.
[379] *Id.* at 310-11, 325-26.
[380] Frans Vanistendael, *General Report on the Fundamental Freedoms and National Sovereignty in the European Union*, http://www.eatlp.org/uploads/Public/General_Report_Frans_Vanistendael.pdf, at 6 (last visited Apr. 13, 2006).

Article 39 speaks in terms of "the abolition of any discrimination,"[381] whereas Articles 49 and 56 prohibit restrictions on the freedom to provide services[382] and the movement of capital[383] respectively. However, in many cases, while the ECJ speaks in terms of restrictions, it in fact applies a nondiscrimination test by focusing on the difference of treatment between the situations.[384]

The only exemptions from the prohibitions in the free movement of goods articles are justifications such as public morality and public policy that are listed in Article 30.[385] There are also justifications recognized under the rule of reason developed by the ECJ in the *Cassis de Dijon* case.[386] Applying the rule of reason in the tax area, the Court has only accepted the need to maintain the integrity of the tax system as such a justification[387] and the scope of this "fiscal cohesion" justification has been limited by the ECJ in subsequent cases.[388] The Court has rejected arguments based on the effectiveness of fiscal supervision,[389] the need to prevent the abuse of EC law,[390] the loss of tax revenue,[391] the absence of tax harmonization,[392] the need to compensate for lower rates of tax in another Member State,[393] and the counterbalancing of a disadvantage with other advantages.[394] Furthermore, even if a justification is accepted, the principle of

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[381] EC Treaty, *supra* note 15, art. 39 (ex art. 48).
[382] EC Treaty, *supra* note 15, art. 49 (ex art. 59).
[383] EC Treaty, *supra* note 15, art. 56 (ex art. 73b).
[384] Lyal, *supra* note 343, at 74.
[385] EC Treaty, *supra* note 15, art. 30. Article 30 also allows restrictions on intra-Community trade if justified on the grounds of "public security, protection of life and health of humans, animals or plants, protection of national treasures possessing artistic value, or protection of industrial and commercial property." *Id.* Discriminatory measures falling within the scope of Articles 39, 49 or 56 may be justified on the grounds of public policy, public security or public health. FARMER & LYAL, *supra* note 289, at 310. *See also* EC Treaty, *supra* note 15, arts. 39(3), 46(1), 58(1)(b).
[386] Case 120/78, Rewe-Zentral AG v. Bundesmonopolverwaltung für Branntwein (Cassis de Dijon), 1979 E.C.R. 649.
[387] Case C-204/90, Hans Martin Bachmann v. Belgium, 1992 E.C.R. I-249. *See also* TERRA & WATTEL, *supra* note 51, at 71-76. Professor Wattel notes that this is inconsistent with nontax case law where the ECJ sometimes allows *rule of reason* justifications even though the "national measure at issue clearly makes a distinction between residents and non-residents or between the domestic situation and the cross border situation." Peter Wattel, *Red Herrings in Direct Tax Cases Before the ECJ*, 31(2) LEGAL ISSUES OF ECONOMIC INTEGRATION 81, 83 (2004).
[388] *See, e.g.*, Case C-80/94, Wielockx v. Inspecteur der Directe Belastingen, 1995 E.C.R. I-2493; Case C-484/93, Svensson v. Ministre du Logement, 1995 E.C.R. I-3955; Case C-251/98, Baars v. Inspecteur der Belastingen Particulieren/Ondernemingen Gorinchem, 2000 E.C.R. I-2787; Case C-35/98, Staatssecretaris van Financien v. B.G.M. Verkooijen, 2000 E.C.R. I-4071; *see also* TERRA & WATTEL, *supra* note 51, at 71-76.
[389] *See, e.g.*, Case C-136/00, Danner, 2002 E.C.R. I-8147, ¶ 48. *But see* Case C-250/95, Futura Participations SA v. Administration des contributions, 1997 E.C.R. I-2471, ¶ 31.
[390] *See, e.g.*, Case C-136/00, Danner, 2002 E.C.R. I-8147, ¶ 54; TERRA & WATTEL, *supra* note 51, at 32-33, 77-80.
[391] *See, e.g.*, Case C-141/99, Algemene Maatschappij voor Investering en Dienstverlening NV v. Belgische Staat, 2000 E.C.R. I-11619 (AMID); Case C-264/96, Imperial Chem. Indus. plc v. Colmer (Her Majesty's Inspector of Taxes), 1998 E.C.R. I-4695 (ICI).
[392] *See, e.g.*, Case 270/83, Comm'n v. French Republic (Avoir Fiscal), 1986 E.C.R. 273.
[393] *See, e.g.*, Case C-107/94, Asscher v. Staatsecretaris van Financien, 1996 E.C.R. I-3089.
[394] *See, e.g.*, Case C-330/91, The Queen v. Inland Revenue Comm'rs, *ex parte* Commerzbank AG, 1993 E.C.R. I-4017; Case C-294/97, Eurowings Luftverkehrs AG v. Finanzamt Dortmund-Unna, 1999 E.C.R. I-7447.

proportionality must be applied. The tax law must be proportionate in its restrictive effect with respect to the legitimate aim pursued meaning that there is no less restrictive yet equally effective way to attain the same goal.[395] This appears to be a more difficult test to meet than the substantial reason test.

The case law has evolved such that all four freedoms prohibit discrimination as well as nondiscriminatory restrictions.[396] Any national law that restricts one of the fundamental freedoms must meet four requirements in order to withstand ECJ scrutiny: 1) the law must be applied in a nondiscriminatory manner; 2) the law must be justified and required by the general interest; 3) the law must be appropriate for securing its objective; and 4) the law must not go beyond what is necessary to attain its objective.[397]

V. Comparative Case Law

In this section, I chose the most recent Supreme Court case that deals with tax discrimination and then examined the ECJ jurisprudence to determine how the European Court of Justice would decide the issue. I selected an individual income tax case because the state corporate tax issues raised in the United States are very different than the issues addressed in the EU.[398] Generally, there is not the kind of tax discrimination that is found in the EU because in the United States, a majority of publicly traded corporations are incorporated in Delaware or in states other than the states in which they operate.[399] Thus, any state in the United States attempting to write a corporate income tax law that discriminates against nonresident corporations could find itself affecting corporations headquartered in its own state. In other words, the U.S. concept of corporate "residency" (place of incorporation) does not necessarily match the reality of where the corporate entity is "resident."[400]

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[395] TERRA & WATTEL, *supra* note 51, at 33.

[396] Paul Farmer, *European Court and Corporate Tax*, 2002 TAX J. 9, 11.

[397] Case C-55/94, Gebhard v. Consiglio dell'Ordine degli Avvocati e Procuratori di Milano, 1995 E.C.R. I-4165, ¶ 37.

[398] *See generally* Walter Hellerstein & Charles E. McLure, Jr., *Lost in Translation: Contextual Considerations in Evaluating the Relevance of U.S. Experience for the European Commission's Company Taxation Proposal*, 58 BULL. INT'L FISC. DOC. 86 (2004). The individual income tax is also more appropriate to analyze because it is a significantly greater share of the total tax revenue collected by both the U.S. and the EU Member States. Most countries raise significantly more revenue from the personal income tax than from the corporate income tax. OECD, REVENUE STATISTICS 1965-2003 103-89 tbls. 42-71 (2005). For example, in 2002, the U.S. received 38% from the personal income tax while only 7% from the corporate tax; while Germany, France, the UK and Poland received 25%, 17%, 30% and 23%, respectively, from individuals; and 3%, 7%, 8% and 6%, respectively, from corporations. *Id.* at 119 tbl. 49, 125 tbl. 50, 158 tbl 63, 175 tbl. 70, 178 tbl. 71 (percentages calculated by author).

[399] ROBERTA ROMANO, THE GENIUS OF AMERICAN CORPORATE LAW 6, 8 (1993). Delaware has been the leading state for incorporation since the 1920's, and more corporations listed on national exchanges are incorporated in Delaware than in any other state. *Id*. "Over 40 percent of the companies listed on the New York Stock Exchange are incorporated in Delaware." Leo Herzel & Laura D. Richman, *Foreword* to R. FRANKLIN BALOTTI & JESSE A. FINKELSTEIN, 1 THE DELAWARE LAW OF CORPORATIONS & BUSINESS ORGANIZATIONS (3d ed. 1998) (citing N.Y.S.E. Guide (CCH) N725-800). "Moreover, the vast majority of reincorporating firms move to Delaware." ROMANO, *supra*, at 6.

[400] ROMANO, *supra* note 399, at 1. "Firms choose their state of incorporation, a statutory domicile that is independent of physical presence and that can be changed with shareholder approval." *Id*.

A. Corporate Taxation

1. The U.S. Approach

Forty-five states and the District of Columbia have enacted state corporate income taxes[401] that broadly conform to the federal corporate income tax.[402] Every state except Arkansas and Mississippi determines the state corporate tax liability by beginning with federal taxable income.[403] The difficulty for the states then is allocating that tax base among themselves when a multistate business is involved, as each state requires the business to pay tax on just a portion of its profit.[404] The tax laws of the majority of the states determine the portion of the corporation's profit that is subject to tax by using an apportionment formula that refers to the shares of the corporation's total property, payroll, and sales located in each state.[405]

Although the states have broad leeway in designing division-of-tax base formulas,[406] they are subject to the constraints of the Due Process and Commerce Clauses[407] and may tax no more than their fair share of the property, income, or receipts

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[401] 2 POMP & OLDMAN, *supra* note 184, at 10-1. Only Nevada, South Dakota, Washington and Wyoming have no corporate income tax. HELLERSTEIN & HELLERSTEIN, *supra* note 170, at 413. Texas's franchise tax resembles a net income tax in many ways. *Id.*

[402] HELLERSTEIN & HELLERSTEIN, *supra* note 170, at 418. Congress enacted a corporate tax law as part of the Payne-Aldrich Tariff Act of 1909, which marked the beginning of the federal government's practice of taxing corporate income. BORIS I. BITTKER & JAMES A. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS 1-3 (7th ed. 2000).

[403] *See* 1 RESEARCH INSTITUTE OF AMERICA, *supra* note 170, at ¶ 221; *see also* HELLERSTEIN & HELLERSTEIN, *supra* note 170, at 418.

[404] HELLERSTEIN & HELLERSTEIN, *supra* note 170, at 418.

[405] Michael Mazerov, *The Single-Sales-Factor Formula: A Boon to Economic Development or a Costly Giveaway?*, 20 ST. TAX NOTES 1775 (2001). Most states' corporate income tax laws have substantially incorporated the provisions of the Uniform Division of Income for Tax Purposes Act (UDITPA), a model law written by the National Conference of Commissioners on Uniform State Laws in 1957. UDITPA contains a three-factor formula for apportioning corporate income whereby the share of a corporation's total profit that a particular state may tax is determined by averaging: 1) the share of the corporation's total sales that are made to residents of the state (the sales factor); 2) the share of the corporation's total payroll that is paid to employees working in the state (the payroll factor); and 3) the share of the corporation's total property that is located in the state (the property factor). *Id.* at 1782. Since then, the double-weighted sales variant of this three-factor apportionment formula has been adopted by most states and has become the new de facto standard. *Id.*

[406] However, Congress may limit a state's taxing authority. *See, e.g.*, Public Law 86-272 (preventing states from taxing corporations when the corporation's only nexus with the state is personal property sales solicitations conducted in the state). Act of Sept. 14, 1959, Pub. L. No. 86-272, 73 Stat. 555-56 (codified as amended at 15 U.S.C. §§ 381-384 (1976)). *See* 2 POMP & OLDMAN, *supra* note 184, at 10-26. *See generally* Kaye, *supra* note 126, at 165; *see also* Charles E. McLure, *The Tax Assignment Problem: Ruminations on How Theory and Practice Depend on History*, 54 NAT'L TAX J. 339, 341 (2001).

[407] *See* Quill Corp. v. North Dakota, 504 U.S. 298, 305 (1992) (stating that "the [Due Process and Commerce] Clauses pose distinct limits on the taxing powers of the States."). Thus, a state may levy a corporate income tax only on the income (or a portion thereof) that has a sufficient nexus with the taxing state. 2 POMP & OLDMAN, *supra* note 184, at 10-7. *See also* Miller Bros. Co. v. Maryland, 347 U.S. 340, 344-45 (1954) (stating that "due process requires some definite link, some minimum connection, between a state and the person, property, or transaction it seeks to tax.").

of the multistate business.[408] Thus, while EU Member States' corporate income tax laws had routinely denied nonresident corporation's branches various tax benefits that are available to resident corporations,[409] the U.S. case law with respect to corporations focuses on issues of state taxation of interstate business. These issues include the risk of multiple taxation, unfair apportionment, and the absence of due process jurisdiction.[410]

2. The EU Approach

Unlike many of the American states, the Member States of the EU use separate accounting to compute the income of each member of a corporate group and arms length prices to value the transactions between the members of the group.[411] Source rules are then used to attribute the income to the "appropriate" Member State.[412] The Commission is exploring the use of a consolidated base with formulary apportionment for European multinationals in lieu of the current system of separate accounting and the arm's length

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[408] HELLERSTEIN & HELLERSTEIN, *supra* note 170, at 419. For a state to impose income tax generated in interstate commerce, there are two requirements: (1) a "minimal connection" between the taxing state and the interstate activities generating the tax and (2) a rational relationship between the income taxed and the activities conducted within the state. *See* Exxon Corp. v. Wisc. Dep't of Revenue, 447 U.S. 207, 219 (1980). *See also* Mobil Oil Corp. v. Comm'r of Taxes, 445 U.S. 425, 436-37 (1980). A state may tax only income that is fairly attributable to a corporation's income-producing activities within the state. *See* Container Corp. of America v. Franchise Tax Bd., 463 U.S. 159 (1983) (a state may not tax income earned outside its borders when imposing an income tax). *See also* ASARCO v. Idaho State Tax Comm'n, 458 U.S. 307, 315 (1982) (stating "a State may not tax value earned outside its borders."); *supra* notes 264-267 and accompanying text.

[409] *See, e.g.,* Case C-330/91, The Queen v. Inland Revenue Comm'rs, *ex parte* Commerzbank AG, 1993 E.C.R. I-4017 (Articles 52 and 58 of the Treaty prevent a Member State from granting repayment on overpaid tax to companies that are resident for tax purposes in that State while refusing the supplement to companies resident for tax purposes in another Member State); Imperial Chem. Indus. plc (ICI) v. Colmer (Her Majesty's Inspector of Taxes), 1998 E.C.R. I-4695 (Article 52 precludes making a particular form of tax relief in a Member State contingent on a holding company's business consisting wholly or mainly in the holding of shares in subsidiaries established in that Member State).

[410] *See, e.g.*, Am. Trucking Ass'ns, Inc. v. Scheiner, 483 U.S. 266 (1987) (challenged taxes do not pass the "internal consistency" test under which a state tax must be of a kind that, if applied by every jurisdiction, there would be no impermissible interference with free trade); Complete Auto Transit, Inc. v. Brady, 430 U.S. 274 (1977) (holding constitutional a Mississippi tax imposed for the privilege of doing business within the state because there were no allegations of insufficient nexus, discrimination, unfair apportionment, or no relation to services provided); Okla. Tax v. Jefferson Lines, 514 U.S. 175 (1995) (finding the tax on the full cost of a bus ticket for interstate travel was 'fairly apportioned' because it reached only activity within the taxing state, that is, the sale of the service); Nw. States Portland Cement Co. v. Minnesota, 358 U.S. 450 (1959) (the state's taxation of a foreign business's income within the state was not unconstitutional, provided that the tax was properly apportioned to local activities within the states and was not discriminatory).

[411] Charles E. McLure, Jr., *Corporate Tax Harmonization for the Single Market: What the European Union is Thinking*, 39 BUS. ECON. 28, 29 (2004). Many states now use combined reporting methods. HELLERSTEIN & HELLERSTEIN, supra note 170, at 519. However, 19 states still do not have combined reporting requirements. *Id.* at 583 tbl. 3.

[412] McLure, *supra* note 411, at 29.

standard.[413] This change is receiving serious consideration because of the complexity of applying 25 Member States' national tax systems if the company operates within the entire European Union.[414] As pointed out by Professors Hellerstein and McLure, depending on how the EU designs their system, such a change would raise many of the issues currently litigated in the United States.[415]

In the state corporate tax area in the United States, Professor Zelinsky has concluded "that the time has come to scrap the dormant Commerce Clause prohibition on discriminatory taxation. Since the judicially-created prohibition has served its historic purpose, to create a single common market of the United States, it can now safely be laid to rest."[416] Zelinsky reaches this conclusion because judges and scholars have been unable to distinguish convincingly between state taxes and states' and localities' direct expenditure programs or to identify a principled basis for declaring which taxes are discriminatory and which are not.[417] The Supreme Court's distinction between discriminatory taxation, which is prohibited under their decisions, and equivalent direct government subsidies, which are generally permitted, is fundamentally incoherent because taxes and subsidies are often similar in design and effect.[418] In light of this doctrinal indeterminacy, Zelinsky believes that the only options are to abandon the nondiscrimination principle in the context of state taxes or expand the dormant Commerce Clause to cover state direct subsidy programs.[419] Because the United States contains a robust network of interstate economic actors with the wherewithal to protect their interests politically, these interstate actors no longer need the protection of this Commerce Clause doctrine.[420]

The EU has avoided such inconsistencies by also prohibiting any state aid through a Member State's tax system. The principle of state aid restrictions as set forth in Articles 87, 88, and 89 prohibits the Member States from granting any advantage that distorts or

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[413] Commission of the European Communities, *Company Taxation in the Internal Market,* Commission Staff Working Paper (Luxembourg: Office for Official Publications of the European Communities, 2002).

[414] *Id*. at 458-60. The European Commission intends to present a legislative proposal in 2008**.** Press Release, European Commission, Company Taxation: Towards a common consolidated corporate tax base, the European Commission presents a progress report and outlines the next steps, (April 5, 2006), available at http://europa.eu.int/rapid/pressReleasesAction.do?reference=IP/06/448&format=HTML&aged=0&language=EN&guiLanguage=en.

[415] Walter Hellerstein & Charles E. McLure, Jr., *The European Commission's Report on Company Income Taxation: What the EU Can Learn from the Experience of the US States*, 11 INT'L TAX & PUB. FIN. 199, (2004) 4-7 (on file with author).

[416] Edward A. Zelinsky, *Restoring Politics to the Commerce Clause: The Case for Abandoning the Dormant Commerce Clause Prohibition on Discriminatory Taxation,* 29 OHIO N.U.L. REV. 29, 29 (2002). Under his proposal, dormant Commerce Clause restraints on state taxation such as the requirement "that taxes be fairly apportioned among the states, that such taxes be levied only by states with a nexus to the taxed activity, and that such taxes be reasonably related to the services the taxpayer receives from the taxing state" would continue. *Id*.

[417] *Id.* at 30.

[418] *Id.* at 31.

[419] *Id.* at 30.

[420] *Id.* at 31.

has the potential to distort competition or trade between the Member States.[421] Although some Member States have argued that these provisions are not applicable to tax measures, the European Commission as well as the Court of First Instance has rejected this argument.[422]

3. Analysis

The current situation in the EU with respect to Member States' national tax systems is reminiscent of the first 100 years of Supreme Court Commerce Clause jurisprudence in that the effect of ECJ case law is that in certain circumstances cross-border activity can receive more advantageous tax treatment than purely domestic activity. Corporate cases in the last five years have found the German thin capitalization rules,[423] the Dutch interest allocation rules,[424] the Austrian foreign-source investment income tax rules,[425] the Finnish corporate tax legislation,[426] and the UK parent-subsidiary loss rules all in violation of EC Treaty law.[427] European commentators have raised the question of whether the Danish controlled foreign corporation (CFC) rules are compatible

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[421] Deloitte EU Study, *supra* note 300, at 16. *See also* Walter Hellerstein, *State Aid Control in the American Federal System*, EUROPEAN COMPETITION LAW ANNUAL 1999: SELECTED ISSUES IN THE FIELD OF STATE AIDS 577 (C. Ehlermann & M. Everson eds., 2001).

[422] Deloitte EU Study, *supra* note 300, at 17 n.105.

[423] *See* Case C-324/00, Lankhorst-Hohorst GmbH v. Finanzamt Steinfurt, 2002 E.C.R. I-11779 (holding that Germany's thin capitalization rules violated the freedom of establishment enshrined in Article 43 of the EC Treaty).

[424] *See* Case C-168/01, Bosal Holding BV v. Staatssecretaris van Financiën, 2003 E.C.R. I-9409 (holding that Council Directive 90/435/EEC precludes a national provision that made the deductibility of costs in connection with a parent company's holdings in a subsidiary established in another Member State contingent on the costs being related to profits that are taxable in the parent company's Member State).

[425] *See* Case C-315/02, Lenz v. Finanzlandesdirektion für Tirol, 2004 E.C.R. I-7063 (holding that a tax rate difference between foreign capital income and domestic capital income infringed on the free movement of capital, which is prohibited under Article 56 of the EC Treaty).

[426] *See* Case C-319/02, Manninen, 2004 E.C.R. I-7477 (holding that a Finnish law that taxed individuals at different rates depending on whether the dividend income was received from Finnish or non-Finnish corporations was incompatible with Article 56 of the EC Treaty). For a more complete discussion of this case, *see supra* notes 362-372.

[427] *Taxing Judgments: Corporate Tax and the EU Court*, THE ECONOMIST, August 28, 2004, at 67-68. *See also* Lee A. Sheppard, *Dowdy U.K. Retailer Set to Destroy European Corporate Tax*, 35 TAX NOTES INT'L 132 (2004). "So off the wall are some ECJ decisions that it is a wonder that European multinationals pay any tax at all." *Id.* at 132-33. In the recent *Marks & Spencer* case, UK legislation preventing the British parent company from using its losses from subsidiaries in other Member States was struck down, provided that the parent company had exhausted its opportunity to deduct the losses in the country where the loss occurred. Case C-446/03, Marks & Spencer plc v. David Halsey (HM Inspector of Taxes), 2005 E.C.R. I-00000, ¶ 59 (ruling that a group relief tax provision that does not permit a parent company to deduct losses from its foreign subsidiary is incompatible with the EC Treaty if those losses cannot be deducted in the country of origin). For the potential impact on a Member State's tax revenue, see Clemens Fuest et al., *The Tax Revenue Implications of Marks & Spencer for Germany*, 38 TAX NOTES INT'L 763 (2005). Germany's possible tax revenue loss is estimated to be as high as 1.5% of the German gross domestic product. *Id*. at 767. *But cf.* Gerard T.K. Meussen, *Cross-Border Loss Relief in the European Union Following the Advocate General's Opinion in the* Marks & Spencer *Case*, 45 EUR. TAX'N 282, 284 (2005) (explaining that the ECJ does not accept possible tax losses as a public interest exception to a violation of a fundamental freedom). For an analysis of Advocate General Maduro's Opinion, see Michael Lang, *The* Marks and Spencer *Case – The Open Issues Following the ECJ's Final Word* , 46 EUR. TAX'N 54 (2006).

with EC law[428] and the Finance and Tax Tribunal referred a question dealing with the UK's CFC legislation to the ECJ on April 29, 2004.[429] European tax scholars are concerned that the pendulum has swung so far in favor of taxpayers as to create a preference for cross-border activity. Denying the Member States the ability to maintain certain domestic anti-avoidance measures jeopardizes tax justice as well as causes substantial losses in the tax revenue of the Member States.[430]

Given the progress made towards the Internal Market, it is time for a more balanced approach that takes into account the Member States' needs to finance their governments. This could be accomplished through a more judicious use of the rule of reason.[431] It seems unreasonable that only one justification has ever been accepted by the ECJ in direct taxation cases.[432] Emilio Cencerrado suggests reliance on Article 4 of the EC Treaty, which obligates the Member States to avoid excessive public deficits.[433] This is accomplished in part through sound tax policies that combat anti-avoidance conduct. Unlike in the United States, in the case of the European Union, it is the judicial branch's decisions that are affecting the Member States' ability to finance their governments.

B. Individual Taxation

1. The U.S. Supreme Court's Approach

The most recently litigated case of individual tax discrimination in the United States is *Lunding v. New York Tax Appeals Tribunal*.[434] In this case, a Connecticut married couple filed a New York nonresident income tax return and took a pro rata deduction of the alimony paid by the husband to the former spouse in proportion to the percentage of the husband's business income that was earned in New York (approximately 48%).[435] The New York State income tax statute did not allow for such a

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[428] Anders Rubinstein & Nikolaj Bjornholm, *News Analysis: Do the* Lenz *and* Manninen *Decisions Invalidate Danish Dividend and CFC Taxation?,* 36 TAX NOTES INT'L 286, 286 (2004).

[429] Case C-196/04, Cadbury Schweppes plc v. Comm'rs of Inland Revenue, 2004 O.J. (C168) 3 (referral to the ECJ for a ruling on the issue of whether tax legislation that provides different rates of taxation for companies with subsidiaries in the same and different Member States is compatible with the EC Treaty). Jens Schönfeld predicts that the ECJ is likely to answer the Special Commissioner's question by replying that the UK CFC legislation is incompatible with the EC Treaty. Jens Schönfeld, *The* Cadbury Schweppes *Case: Are the Days of the United Kingdom's CFC Legislation Numbered?*, 44 EUR. TAX'N 441, 452 (2004). The United Kingdom's CFC legislation is also being challenged in Case C-203/05, Vodafone 2 v. Her Majesty's Revenue and Customs. Hans van den Hurk, et al., *EU Tax Review*, 39 TAX NOTES INT'L 39, 41 (2005).

[430] Emilio Cencerrado, *Controlled Foreign Company and Thin Capitalization Rules are not Applicable in Spain to Entities Resident in the European Union*, 13 EC TAX REV. 102, 103 (2004). Interestingly, Germany responded to the *Lankhorst* judgment by extending their legislation to lender companies resident in Germany as well whereas Spain amended their legislation to exempt all residents of the EU unless the territory is classified as a tax haven. *Id*. at 105.

[431] Luc Hinnekens, *Forum: European Court Goes for Robust Tax Principles for Treaty Freedoms. What About Reasonable Exceptions and Balances?*, 13 EC TAX REV. 65, 66 (2004).

[432] *See infra* Part IV.

[433] Cencerrado, *supra* note 430, at 107.

[434] 522 U.S. 287 (1998).

[435] *Id.* at 293.

deduction for nonresidents.[436] The deduction was denied and the Department of Taxation and Finance recalculated the couple's tax liability.[437] The recalculated New York State tax liability was 14.8% higher than what a New York resident with the same income and alimony would be required to pay.[438] The Lundings appealed the assessment through the administrative process and then through the New York State court system.[439] The taxpayers asserted that New York's tax provision violated the Privileges and Immunities Clause because it resulted in a nonresident's tax liability being greater than if the nonresident was a resident.[440]

The New York Court of Appeals upheld the constitutionality of the New York statute's disparate tax treatment of alimony paid by a nonresident as fully justified because in effect "the advantage granted residents is offset by the additional burden of being taxed on all sources of income."[441] The "substantial reason test" created in the *Toomer v. Witsell* case,[442] allows a state's disparate treatment of nonresidents only when they have a valid independent reason. The New York Court of Appeals asserted that *Shaffer v. Carter*[443] and *Travis v. Yale & Towne Manufacturing Co.*[444] "established that limiting taxation of nonresidents to their in-State income was a sufficient justification for similarly limiting their deductions to expenses derived from sources producing that in-State income." [445] Thus, the New York Court of Appeals agreed with New York State's argument that the nonresident discrimination was justified given that nonresidents were only taxed on in-state income while residents were taxed on worldwide income.[446] The Court of Appeals' finding that alimony payments are "wholly linked to personal activities outside the State" was further justification for the disallowance.[447]

The Supreme Court reversed and declared the tax provision unconstitutional in a six to three decision.[448] The majority held that the New York tax provision violated the Privileges and Immunities Clause because the state had not presented a substantial

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[436] *Lunding*, 522 U.S at 291-93 (citing N.Y. TAX LAW § 631(b)(6) (McKinney 1997), which states that the deduction for alimony "shall not constitute a deduction derived from New York sources.").
[437] *Id.* at 293.
[438] Brief for Petitioners at 4, *Lunding* (No. 96-1462).
[439] After the department of Taxation and Finance denied the deduction, the Lundings appealed to the New York Division of Tax Appeals where they were also denied. They then brought an action before the Appellate Division of the New York Supreme Court. *Lunding,* 522 U.S. at 293. *See also* Lunding v. Tax App. Trib., 639 N.Y.S.2d 519 (N.Y. App. Div. 1996), *rev'd*, Lunding v. Tax App. Trib., 675 N.E.2d 816 (N.Y. 1996), *rev'd*, Lunding v. N.Y. Tax App. Trib., 522 U.S. 287 (1998). "The New York Division of Taxation, the State Tax Appeals Tribunal, and the New York Court of Appeals determined that he was not entitled to the deduction; only the Appellate Division, Third Department, found fault with New York's denial of the alimony deduction." Diann Lee Smith, *New York: Denial of Alimony Deduction for Nonresidents Unconstitutional,* 10 MULTISTATE TAX ANALYST 8 (1998).
[440] *Lunding*, 522 U.S. at 293. For a critique of this position, see Michael J. McIntyre & Richard D. Pomp, *Post-Marriage Income Splitting Through Deduction for Alimony Payments: A Reply to Professor Schoettle on* Lunding v. New York, 13 ST. TAX NOTES 163 (1997).
[441] Lunding v. Tax App. Trib., 675 N.E. 2d 816, 821 (N.Y. 1996), *rev'g*, 639 N.Y.S.2d 519 (N.Y. App. Div. 1996).
[442] 334 U.S. 385, 396 (1948).
[443] 252 U.S. 37 (1920).
[444] 252 U.S. 60 (1920).
[445] *Lunding*, 675 N.E.2d at 819.
[446] *Id*. at 821.
[447] *Id.*
[448] *Lunding*, 522 U.S. at 289-90.

justification for the discriminatory treatment of nonresidents.[449] Although the Privileges and Immunities Clause affords no assurance of precise equality in taxation between residents and nonresidents of a particular State,[450] New York failed to assert "a substantial justification for its different treatment of nonresidents, including an explanation of how the discrimination relates to the State's justification."[451]

Justice O'Connor, writing for the majority, pointed out that the purpose of the Privileges and Immunities Clause is to "strongly . . . constitute the citizens of the United States one people," by "placing the citizens of each State upon the same footing with the citizens of other States, so far as the advantages resulting from citizenship in those States are concerned."[452] One such advantage is the right of a citizen of any State to "remove to and carry on business in another without being subjected in property or person to taxes more onerous than the citizens of the latter State are subjected to."[453] She noted that there were other provisions within New York's tax scheme that allowed for a proportionate deduction by nonresidents of personal expenses other than alimony.[454] Therefore, "[a]lthough the State has considerable freedom to establish and adjust its tax policy respecting nonresidents, the end results must, of course, comply with the Federal Constitution, and any provision imposing disparate taxation upon nonresidents must be appropriately justified."[455] Citing *Travis*,[456] the Court held that nonresidents must be allowed tax exemptions in parity with residents.[457]

The Court also rejected New York's second justification that alimony was linked to Lunding's personal life outside the state.[458] The Court distinguished alimony from valid disallowances such as business losses from out-of-state activities, because alimony is not "geographically fixed in the manner that other expenses, such as business losses, mortgage interest payments, or real estate taxes, might be."[459] The majority argued that alimony, while personal, bore some relationship to Lunding's overall earnings including amounts earned in New York.[460] "[A]limony payments reflect an obligation of some duration that is determined in large measure by an individual's income generally, wherever it is earned."[461]

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[449] *Id.* at 315. "[A] State may defend its position by demonstrating that (i) there is a substantial reason for the difference in treatment; and (ii) the discrimination practiced against nonresidents bears a substantial relationship to the State's objectives." *Id.* at 298 (citing Supreme Court of N.H. v. Piper, 470 U.S. 274, 284 (1985)).
[450] *Id.* at 297.
[451] *Id.* at 299.
[452] *Id.* at 296 (citing Paul v. Virginia, 75 U.S. (8 Wall.) 168, 180 (1869)).
[453] *Id.* (citing Shaffer v. Carter, 252 U.S. 37, 56 (1920)). *See also* Toomer v. Witsell, 334 U.S. 385, 396 (1948); Ward v. Maryland, 79 U.S. (12 Wall.) 418, 430 (1871).
[454] *Lunding*, 522 U.S. at 308.
[455] *Id.*
[456] Travis v. Yale & Towne Mfg. Co., 252 U.S. 60, 79-80 (1920).
[457] *Lunding*, 522 U.S. at 309.
[458] *Id.* at 304-05.
[459] *Id*. at 311.
[460] *Id.* at 310, 314. "Alimony payments also differ from other types of personal deductions, such as mortgage interest and property tax payments, whose situs can be determined based on the location of the underlying property." *Id*. at 310.
[461] *Id*. "And as a personal obligation that generally correlates with a taxpayer's total income or wealth, alimony bears some relationship to earnings regardless of their source." *Id*. at 314.

The dissenters, Justice Ginsburg, Chief Justice Rehnquist, and Justice Kennedy, disagreed with this contention noting that other factors such as the length of the marriage, the recipient's earnings, and child custody and support arrangements are more significant influences.[462] Criticizing the majority's approach as inconsistent, the dissent argued that the majority's holding would require states to allow nonresidents every personal deduction allowed to residents.[463]

2. The European Court of Justice's Approach

Thus, *Lunding* raised the following fundamental question: Is a State constitutionally required to extend to nonresident taxpayers who are subject to tax only on income arising within that State the same personal deductions and other related allowances that it grants to its residents, who are taxable on their worldwide income?[464] The European Court of Justice has had essentially the same question referred to it by Member State national courts since the *Avoir Fiscal* case was decided in 1986.[465] This section will focus on a line of cases examining this problem as it arises for individual taxpayers with respect to the income tax. Although the *Schumacker* case[466] was the first in this line of individual income tax cases, I will begin by discussing the *Wielockx* case[467] as its fact pattern is more analogous to that of *Lunding.*

In *Wielockx*, the European Court of Justice dealt with a similar issue to that examined in *Lunding*. Mr. Wielockx, a Belgian national resident in Belgium, challenged the Inspector of Taxes of the Netherlands concerning the latter's refusal to allow a deduction for his contributions to a pension reserve.[468] Mr. Wielockx was self-employed and had a physiotherapy practice in the Netherlands where he received his entire income. Thus, he had to pay income tax in the Netherlands.[469]

The Netherlands 1964 Law on Income Tax "defines 'national taxpayers' as natural persons resident in the Netherlands as opposed to 'foreign taxpayers', natural persons who are not resident in the Netherlands but who do receive income there."[470] A voluntary pension-reserve tax scheme was adopted in 1972, allowing self-employed persons "to allocate a proportion of the profits of their business to form a pension reserve . . . ."[471] The 1964 law provided that "national taxpayers" (the residents) "are subject to tax on the income arising from their business profits, reduced by amounts added to the pension reserve and increased by amounts taken out of it."[472] Under the 1964 law,

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[462] *Id.* at 327 (Ginsburg, J., dissenting).
[463] *Id.*
[464] McIntyre & Pomp, *supra* note 172, at 246.
[465] *See supra* notes 338-343 and accompanying text.
[466] Case C-279/93, Finanzamt Köln-Altstadt v. Schumacker, 1995 E.C.R. I-225.
[467] Case C-80/94, Wielockx v. Inspecteur der Directe Belastingen, 1995 E.C.R. I-2493.
[468] *Id.* ¶ 2.
[469] *Id.* ¶ 10.
[470] *Id.* ¶ 3.
[471] *Id.* ¶ 4.
[472] *Id.* ¶ 5. "[W]hen the taxpayer reaches the age of 65, the pension reserve is to be liquidated. It is then treated as income and taxed either once on the total capital or as and when periodic payments are made from that capital. *Id.* ¶ 6.

"foreign taxpayers" (the nonresidents) "are taxed solely on their 'taxable national income,' namely their total income in the Netherlands during a calendar year as reduced by losses."[473]

The ECJ was asked whether Article 52 (now Art. 43) prohibits a Member State from permitting residents to deduct a pension reserve from their taxable income, while denying such a deduction to Community national taxpayers who, "although resident in another Member State, receive all or almost all of their income in the first State."[474] Is that difference in treatment "justified by the fact that the periodic pension payments subsequently drawn out of a pension reserve by the non-resident taxpayer are not taxed in the State in which he works but in the State of residence . . . ?"[475] Here the Netherlands was invoking the *Bachmann* justification,[476] that it is essential to the cohesion of their tax system to maintain tax symmetry between the deductibility of the contributions and the taxability of the subsequent receipts within the same tax jurisdiction.[477]

While acknowledging that "direct taxation falls within the competence of the Member States . . . ," the Court reiterated that Member States must "avoid any overt or covert discrimination by reason of nationality."[478] "[D]iscrimination arises through the application of different rules to comparable situations or the application of the same rule to different situations."[479] A difference in treatment between resident and nonresident taxpayers "cannot therefore in itself be categorized as discrimination within the meaning of the Treaty."[480] However, a nonresident taxpayer "who receives all or almost all of his income in the State where he works is objectively in the same situation . . ." as a resident of that State who also works there because both are taxed in that State alone.[481] Therefore, if a nonresident taxpayer is not allowed the same tax deductions, his personal situation will not be taken into account in either State.[482] "Consequently his overall tax burden will be greater and he will be at a disadvantage compared to a resident."[483]

The Court found that a nonresident taxpayer who "receives all or almost all of his income in the State where he works but who is not entitled to set up a pension reserve qualifying for deductions under the same tax conditions as a resident taxpayer suffers discrimination."[484] The Netherlands's attempt to justify this discrimination based "on the principle of fiscal cohesion laid down in . . ." *Bachmann*[485] was dismissed by the

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[473] *Id.* ¶ 7.
[474] *Id.* ¶ 13.
[475] *Id.* ¶ 14.
[476] Case C-204/90, Bachmann v. Belgium, 1992 E.C.R. I-249 (accepting the necessity of preserving the fiscal cohesion of the applicable tax system as a justification for making the deductibility of annuity contributions contingent on their being paid in that State); *see also supra* note 327.
[477] Wattel, *supra* note 52, at 239.
[478] Case C-80/94, Wielockx v. Inspecteur der Directe Belastingen, 1995 E.C.R. I-2493, ¶ 16 (citing Case C-279/93, Finanzamt Köln-Altstadt v. Schumacker, 1995 E.C.R. I-225, ¶¶ 21, 26).
[479] *Id.* ¶ 17.
[480] *Id.* ¶ 19.
[481] *Id.* ¶ 20.
[482] *Id.* ¶ 21.
[483] *Id.*
[484] *Id.* ¶ 22.
[485] Case C-204/90, Bachmann v Belgium, 1992 E.C.R. I-249.

Court.[486] The Court held that fiscal cohesion had been achieved by virtue of the bilateral convention concluded with Belgium.[487] The discriminatory treatment could not be "justified by the fact that the periodic pension payments subsequently drawn out of the pension reserve by the non-resident taxpayer . . ." would be taxed in the State of residence pursuant to the respective Member State's double taxation treaty.[488]

Previously in the *Schumacker* case,[489] the ECJ had closely examined the distinction drawn in national tax laws between residents and nonresidents when a Belgian national challenged the way Germany taxed his earnings as an employee.[490] Mr. Schumacker earned his income in Germany while living in Belgium with his wife who did not work outside the home.[491] Pursuant to a double taxation treaty between Belgium and Germany, Germany was entitled to tax his income.[492] Under German tax law, different tax regimes are applied to persons depending on their residence.[493] Residents of Germany are subject there to tax on all their income ("unlimited taxation") while individuals with no permanent residence in Germany are subject to tax only on the part of their income arising from employment in Germany ("limited taxation").[494]

To calculate the tax, "employed persons subject to unlimited taxation are divided into several taxation categories . . . ."[495] Married individuals who are not separated may use the "splitting" tariff provided that both spouses are German residents subject to unlimited taxation.[496] The "splitting" tariff was designed to mitigate the progressive nature of the income tax rates by aggregating the spouses' total income, attributing 50% to each spouse and then taxing accordingly.[497]

Mr. Schumacker asked the Finanzamt to calculate his tax on an equitable basis, by reference to the "splitting" tariff.[498] The German tax authority refused to refund the extra

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[486] Case C-80/94, Wielockx v. Inspecteur der Directe Belastingen, 1995 E.C.R. I-2493, ¶ 23. The *Bachmann* judgment has been severely criticized for ignoring the bilateral treaty in effect between Belgium and Germany. Wattel, *supra* note 52, at 240.

[487] Case C-80/94, Wielockx v. Inspecteur der Directe Belastingen, 1995 E.C.R. I-2493, ¶ 25. The ECJ explained:

> [T]he effect of double-taxation conventions which, like the one referred to above, follow the OECD model is that the State taxes all pensions received by residents in its territory, whatever the State in which the contributions were paid, but, conversely, waives the right to tax pensions received abroad even if they derive from contributions paid in its territory which it treated as deductible. Fiscal cohesion has not therefore been established in relation to one and the same person by a strict correlation between the deductibility of contributions and the taxation of pensions but is shifted to another level, that of the reciprocity of the rules applicable in the Contracting States.

Id. ¶ 24. Professor Wattel calls this the invention of "macro-cohesion." Wattel, *supra* note 52, at 238.

[488] Case C-80/94, Wielockx v. Inspecteur der Directe Belastingen, 1995 E.C.R. I-2493, ¶ 27.

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

[490] *See* Elizabeth Keeling, *Some Observations on* Finanzamt Köln-Altstadt v. Schumacker, 1 EC TAX J. 135 (1995-96).

[491] Case C-279/93, Finanzamt Köln-Altstadt v. Schumacker, 1995 E.C.R. I-225, ¶ 15.

[492] *Id.* ¶ 16.

[493] *Id.* ¶ 3.

[494] *Id.* ¶¶ 4, 5.

[495] *Id.* ¶ 7.

[496] *Id.*

[497] *Id.*

[498] *Id.* ¶ 17.

taxes deducted from his wages due to his tax classification as an unmarried person.[499] Under the legislation in force at the time, persons subject to limited taxation came within this category regardless of their family circumstances.[500] Consequently, they did not qualify for the tax benefit of "splitting" and nonresident married employed persons were treated in the same way as unmarried persons. Schumacker appealed his case to the *Bundesfinanzhof* (Federal Tax Court).[501]

The *Bundesfinanzhof* asked for a preliminary ruling from the ECJ with respect to the following questions (as summarized):

1. Does Article 48 of the EEC Treaty restrict the right of Germany to levy income tax on a national of another Member State? If so:
2. Does Article 48 allow Germany to impose a higher level of income tax on a Belgian resident than on an otherwise comparable person resident in Germany, if he commences employment in Germany without transferring his permanent residence there?
3. Does it make any difference if the Belgian referred to above derives almost all (that is over 90%) of his income from Germany and this income is only taxable in Germany, in accordance with the Double Taxation Agreement between Germany and Belgium?
4. Is it contrary to Article 48 for Germany to exclude nonresidents who derive income from employment in Germany from the benefit of annual adjustment procedures that are available to residents?[502]

After reviewing the German legislation and rationale, the ECJ explained that the principle of free movement of persons within the Community limits the right of a Member State to enforce discriminatory provisions with respect to the taxation of a national of another Member State.[503] The Court stated that although "direct taxation does not as such fall within the purview of the Community, the powers retained by the Member States must nevertheless be exercised consistently with Community law . . . ."[504] "Article 48(2) of the Treaty [now Art. 39(2)] requires the abolition of any discrimination based on nationality between workers of the Member States as regards, *inter alia*, remuneration."[505] The Court stated that the principle of equal treatment with regard to remuneration would be rendered ineffective if it could be undermined by discriminatory national provisions on income tax.[506]

With respect to questions two and three, the Court found that where a distinction is drawn on the basis of residence, the rule is likely to operate to the detriment of nationals of other Member States.[507] Indirect discrimination does arise when different

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[499] *Id.* ¶ 18.
[500] *Id.* ¶ 12.
[501] *See* Nils Mattsson, *Does the European Court of Justice Understand the Policy Behind Tax Benefits Based on Personal and Family Circumstances?,* 43 EUR. TAX'N 186 (2003).
[502] Case C-279/93, Finanzamt Köln-Altstadt v. Schumacker, 1995 E.C.R. I-225, ¶ 19.
[503] *Id.* ¶ 24.
[504] *Id.* ¶ 21 (citing Case C-246/89, Comm'n v. United Kingdom, 1991 E.C.R. I-4585, ¶ 12).
[505] *Id.* ¶ 22.
[506] *Id.* ¶ 23 (citing Case C-175/88, Biehl v. Admin. des Contributions, 1990 E.C.R. I-1779).
[507] *Id.* ¶ 28. The ECJ explained:

rules are applied to comparable situations.[508] Because Schumacker earned a major part of his income in Germany and was not entitled to any tax benefits in Belgium on account of his family circumstances, he was comparably situated to a resident of Germany. Thus, the Community principle of equal treatment requires that Germany consider his personal and family circumstances and grant him the same tax benefits as residents.[509] As to the fourth question, Article 48 (now Art. 39) mandates equal treatment at the procedural level for nonresident and resident EU nationals.[510] The ECJ found that the refusal to grant these nonresidents the benefit of the annual adjustment procedures that were available to residents constituted unjustified discrimination.[511]

Note that in both the *Schumacker* and *Wielockx* cases, the Court examines the overall tax situation of the taxpayer (and only that specific taxpayer) and looks at the home state position as well as the host state situation.[512] The specific taxpayer analysis is disregarded in the Supreme Court's opinion in *Lunding.* Instead, the Supreme Court takes a more global approach:

> [W]e are not satisfied by the State's argument that it need not consider the impact of disallowing nonresidents a deduction for alimony paid merely because alimony expenses are personal in nature, particularly in light of the inequities that could result when a nonresident with alimony obligations derives nearly all of her income from New York, a scenario that may be 'typical.'[513]

However, the Supreme Court rejected an attempt by various States, as *amici* for respondents, to assert that the effect of New York's statute was de minimis given that "States imposing an income tax typically provide a deduction or credit to their residents for income taxes paid to other States."[514] This was not the case for Mr. Lunding, as Connecticut imposed no income tax on earned income for the year in question.[515] Finally, the Court admonished that "the constitutionality of one State's statutes affecting nonresidents [cannot] depend upon the present configuration of the statutes of another State."[516]

> [N]ational rules . . . under which a distinction is drawn on the basis of residence in that non-residents are denied certain benefits which are, conversely, granted to persons residing within national territory, are liable to operate mainly to the detriment of nationals of other Member States. Non-residents are in the majority of cases foreigners.

Id.

[508] *Id.* ¶ 30.

[509] *Id.* ¶ 41.

[510] *Id.* ¶ 58.

[511] *Id.*

[512] Farmer, *supra* note 312, at 77.

[513] Lunding v. N.Y. Tax App. Trib., 522 U.S. 287, 311 (1998) (citing Travis v. Yale & Towne Mfg. Co., 252 U.S. 60, 80 (1920)).

[514] *Id.* at 313 (citing Brief for State of Ohio *et al.* 8). Thus, "the taxpayer would pay roughly the same total tax in the two States, the only difference being that [the taxpayer's resident State] would get more and New York less of the revenue." *Id*.

[515] *Id*. at 314 (citing Reply Brief for Petitioners 4 n.1).

[516] *Id*. (citing Austin v. New Hampshire, 420 U.S. 656, 668 (1975)); *see also Travis*, 252 U.S. at 81-82.

In *Schumacker* and *Wielockx* the taxpayers won their cases because although the situations of residents and of nonresidents are not, as a rule, comparable,[517] "the position is different where the nonresident receives no significant income in the State of his residence and obtains the major part of his taxable income from an activity performed in the State of employment . . . ."[518] Because Mr. Wielockx derived all of his income in the Netherlands and Mr. Schumacker earned 90% of his income in Germany, these Member States were not justified in treating them differently than residents with respect to the tax treatment of their personal and family circumstances.[519] The question that naturally arose next was what constitutes "the major part" of a taxpayer's income.[520] This question was dealt with in the *Gschwind* case.[521]

In *Gschwind*, the ECJ also interpreted an Article 48 (now Art. 39) question raised by a Dutch national regarding taxes assessed on his income from employment in Germany.[522] Mr. Gschwind lived in the Netherlands with his wife. In 1991 and 1992, Mr. Gschwind was employed in Germany earning approximately 58% of the couple's total income while his wife was employed in the Netherlands.[523] Pursuant to the income tax treaty between Germany and the Netherlands, Mr. Gschwind paid income tax on his earnings to Germany and his wife paid income tax to the Netherlands.[524]

Under the German income tax code, a married couple is able to apply for a joint assessment and use a splitting procedure that results in a lower tax liability.[525] However, for the splitting procedure to apply to nonresident couples, 90% of the couple's total income must be taxable in Germany.[526] Thus, for the 1991 and 1992 tax years, Mr. Gschwind was treated as if he was single and forced to pay an additional tax liability.[527] After Mr. Gschwind's objection to his treatment as an unmarried person was dismissed, he appealed to the Tax Court of Cologne, which referred the question to the ECJ for a preliminary ruling.[528] Essentially, the issue was:

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[517] Case C-279/93, Finanzamt Köln-Altstadt v. Schumacker, 1995 E.C.R. I-225, ¶ 31; Case C-80/94, Wielockx v. Inspecteur der Directe Belastingen, 1995 E.C.R. I-2493, ¶ 18.

[518] Case C-279/93, Finanzamt Köln-Altstadt v. Schumacker, 1995 E.C.R. I-225,. ¶ 36; *see also* Case C-80/94, Wielockx v. Inspecteur der Directe Belastingen, 1995 E.C.R. I-2493, ¶ 20.

[519] Case C-279/93, Finanzamt Köln-Altstadt v. Schumacker, 1995 E.C.R. I-225, ¶ 36*;* Case C-80/94, Wielockx v. Inspecteur der Directe Belastingen, 1995 E.C.R. I-2493, ¶ 22.

[520] Case C-279/93, Finanzamt Köln-Altstadt v. Schumacker, 1995 E.C.R. I-225, ¶ 36; Case C-80/94, Wielockx v. Inspecteur der Directe Belastingen, 1995 E.C.R. I-2493, ¶ 13.

[521] Case C-391/97, Gschwind v. Finanzamt Aachen-Auβenstadt, 1999 E.C.R. I-5451.

[522] *Id.* ¶¶ 2, 9.

[523] *Id.* ¶¶ 9, 10.

[524] *Id.* ¶ 10.

[525] *Id.* ¶ 4.

[526] *Id.* ¶ 6. Germany had amended their income tax law in 1995 in order to take into account the judgment by the ECJ in the *Schumacker* case. *See supra* notes 489-500, 502-509 and accompanying text.

[527] Case C-391/97, Gschwind v. Finanzamt Aachen-Auβenstadt, 1999 E.C.R. I-5451, ¶ 11. Mr. Gschwind did not request personal deductions in Germany but rather only sought the splitting benefit. In the tax regime of the Netherlands that seeks to avoid double taxation, Mr. Gschwind lost his basic allowance and all other personal deductions available to residents. 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 EUR. TAX'N 210, 218 (2000).

[528] Case C-391/97, Gschwind v. Finanzamt Aachen-Auβenstadt, 1999 E.C.R. I-5451, ¶¶ 12, 13. The question referred to the Court was:

> Is it contrary to Article 48 of the EC treaty for Paragraph 1(3), second sentence, in conjunction with Paragraph 1a1.2 of the Einkomensteuergesetz (German Law on Income

> whether Article 48(2) of the Treaty precludes the application of a Member State's legislation that grants resident married couples favourable tax treatment . . . , yet makes the same treatment of non-resident married couples subject to the condition that at least 90% of their total income must be subject to tax in that Member State or . . . , that their income from foreign sources not subject to tax in that State must not be above a certain ceiling.[529]

The ECJ concluded that the treatment of the Gschwind family by the German tax authority was not discriminatory in violation of Article 48(2) (now Art. 39(2)).[530] In order for a nonresident couple to be protected under the *Schumacker* doctrine, three elements must be met: (1) the couple earns no significant income in their state of residence, (2) the tax the couple is required to pay in the foreign state is higher than a resident couple would pay, and (3) the couple is similarly situated to a resident couple in that they derive the major part of their taxable income from activity in the State of employment.[531] In these circumstances, the State of residence is not in a position to grant tax benefits resulting from the taking into account of the personal and family circumstances. Thus the State of employment must do so. In the Gschwinds' case, the Court assumed that the Netherlands would take into account the personal and family circumstances of Mr. Gschwind, despite his lack of income in the state, because of the 42% of income brought to the couple's combined income by his wife in the resident State.[532] Because 58% of total income in state of employment is not enough to earn ECJ protection, I conclude that the ECJ also would not have found in Mr. Lunding's favor.

However, evidence that the ECJ might protect Mr. Lunding can be found in the ECJ's judgment in the *Schempp* case.[533] The German Federal Tax Court asked for a preliminary ruling from the ECJ with respect to whether the non-deductibility of maintenance payments from a German resident taxpayer to his ex-spouse residing in Austria constitutes tax discrimination based on Articles 12 and 18.[534] Maintenance payments by a German resident to a divorced spouse are generally deductible and are also regarded as taxable income to the recipient.[535] However, where the ex-spouse resides in

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> Tax) to provide that a Netherlands national deriving taxable income from employment in Germany without having a permanent residence or usual abode there and his spouse, who is not permanently separated from him and likewise has no permanent residence or usual abode in Germany and earns income abroad, are not to be treated as persons subject to unlimited taxation for the purposes of applying Paragraph 26(1), first sentence of the Einkommensteuergesetz (joint assessment) on the ground that the combined income of the spouses for the calendar year in question does not fall as to at least 90% within the Einkommensteuergesetz, or that the income not subject to the Einkommensteuergesetz amounts to more than DEM 24 000?

Id. ¶ 13.
[529] *Id.* ¶ 14.
[530] *Id.* ¶ 32.
[531] *Id.* ¶ 27.
[532] *Id.* ¶ 29.
[533] Case C-403/03, Egon Schempp v. Finanzamt Munchen V, 2005 E.C.R 00000.
[534] *Id.* ¶ 11.
[535] *Id.* ¶ 4.

another Member State, the recipient must prove through production of a certificate issued by the relevant taxing authorities that the maintenance payments will be taxed.[536] Mr. Schempp was unable to produce the certificate because Austria does not tax maintenance payments.[537] Schempp argued that he suffered discrimination because had his former wife been resident in Germany, he would have been able to deduct these maintenance payments.[538] This would be true even though his spouse would not have actually paid any German income tax, as her income was less than the taxable minimum.[539]

The ECJ found that this German income tax provision is not incompatible with the EC Treaty.[540] "[T]he payment of maintenance to a recipient resident in Germany cannot be compared to the payment of maintenance to a recipient in Austria. The recipient is subject in each of those two cases, as regards taxation of the maintenance payments, to a different tax system."[541] Thus, Articles 12 or 18 do not prohibit the German tax law because the criterion used in the tax law relates solely to the tax treatment of the maintenance payments in the Member State of residence of the recipient and not in any way to the nationality or residence of the payer of the maintenance payments.[542] The ECJ points out that if Mr. Schempp's former wife moved to the Netherlands where maintenance allowances are subject to taxation, Mr. Schempp would be able to benefit fully from the maintenance payment deduction.[543] This is not the case in *Lunding*, where the deduction of alimony was clearly dependent on the residence of the payer. A resident of New York gets the deduction whereas a nonresident does not regardless of the tax circumstances of the recipient.

The *de Groot* case,[544] however, demonstrated some problems with the *Schumacker* doctrine. In this case, the ECJ had to tackle the question of whether Article 48 (now Art. 39) precludes a national tax law system that proportionally decreases a resident's personal tax benefits on account of employment income from other Member States.[545] Mr. de Groot was a resident of the Netherlands but also earned significant income from Germany, France and the United Kingdom.[546] He paid taxes in these three countries and also paid tax in the Netherlands.[547] Although the Netherlands exempted the foreign income pursuant to the respective tax treaties with Germany, France and the United Kingdom, the foreign income was taken into account for purposes of computing the appropriate progressive rate.[548] After calculating tax on total income, a tax relief amount was calculated by multiplying the tax by a proportionality factor (foreign gross income divided by total gross income).[549] As a result of this calculation, Mr. de Groot

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[536] *Id.* ¶ 8.
[537] *Id.* ¶ 9.
[538] *Id.; see also* Claudia Daiber, *Multinational Tax Cases Top ECJ Agenda*, 37 TAX NOTES INT'L 966, 966-67 (2005).
[539] Case C-403/03, Egon Schempp v. Finanzamt Munchen V, 2005 E.C.R. 00000, ¶ 39.
[540] *Id.* ¶ 47; Daiber, *supra* note 538, at 967.
[541] Case C-403/03, Egon Schempp v. Finanzamt Munchen V, 2005 E.C.R. 00000, ¶ 35.
[542] *Id.* ¶¶ 34, 36-37.
[543] *Id.* ¶ 33.
[544] Case C-385/00, de Groot v. Staatssecretaris van Financien, 2002 E.C.R. I-11819.
[545] *Id.* ¶ 46.
[546] *Id.* ¶ 27.
[547] *Id.* ¶¶ 30, 31.
[548] *Id.* ¶ 21.
[549] *Id.* ¶ 18.

lost a proportionate share of his tax deduction (more than 60%), which included a proportionate share of his alimony deduction.[550] Neither Germany, France, nor the United Kingdom took his alimony deduction into account for purposes of calculating his tax liability in each of these countries.[551]

Mr. de Groot observed that the free movement of persons provisions of the EC Treaty are intended to preclude any national legislation that would place Community citizens at a disadvantage because they engage in cross-border activities.[552] He claimed that he was disadvantaged, comparing his tax liability with the tax he would pay the Netherlands if he worked exclusively in the Netherlands.[553] Instead, he received a smaller tax deduction because his employment income was earned from several Member States.[554] The ECJ agreed with de Groot and reasoned that although "the rules on freedom of movement for workers are intended, in particular, to secure the benefit of national treatment in the host State, they also preclude the State of origin from obstructing the freedom of one of its nationals to accept and pursue employment in another Member State . . . ."[555] Overruling accepted tax principles, the ECJ required the State of residence to grant all of the personal allowances regardless of the fact that the tax system of the Netherlands exempted foreign income from taxation.[556] With respect to the argument that the disadvantage suffered by the taxpayer was compensated for by the lack of a progressive tax rate being applied by the other tax jurisdictions, the ECJ found "that detrimental tax treatment contrary to a fundamental freedom cannot be justified by the existence of other tax advantages, even if those advantages exist . . . ."[557]

However, in a more recent direct tax decision with respect to the free movement of services, the ECJ confirmed the generally accepted allocation of the right to tax among residence and source states.[558] In *Gerritse*,[559] the ECJ had to tackle the question of whether Article 59 (now Art. 49) precludes a national law that taxes gross income when taxing nonresidents but net income when taxing residents.[560] Mr. Gerritse, a national and

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[550] *Id.* ¶¶ 29, 37.
[551] *Id.* ¶ 30.
[552] *Id.* ¶ 48.
[553] *Id.* ¶ 49.
[554] *Id.*
[555] *Id.* ¶ 79.
[556] *Id.* ¶ 98. As the ECJ explained,

> [T]he mechanisms used to eliminate double taxation or the national tax systems which have the effect of eliminating or alleviating double taxation must permit the taxpayers in the States concerned to be certain that, as the end result, all their personal and family circumstances will be duly taken into account . . . .

Id. ¶ 101.
[557] *Id.* ¶ 97 (citing with respect to the freedom of establishment, Case 270/83, Comm'n v. French Republic, 1986 E.C.R. 273 (Avoir Fiscal), ¶ 21; Case C-107/94, Asscher v. Staatsecretaris van Financien, 1996 E.C.R. I-3089, ¶ 53; Case C-307/97, Compagnie de Saint-Gobain, Zweigniederlassung Deutschland v. Finanzamt Aachen-Innenstadt, ¶ 54; with respect to the freedom to provide services, Case C-294/97, Eurowings Luftverkehrs AG v. Finanzamt Dortmund-Unna, 1999 E.C.R. I-7447, ¶ 44; and, with respect to the free movement of capital, Case C-35/98, Staatssecretaris van Financien v. B.G.M. Verkooijen, 2000 E.C.R. I-4071, ¶ 61).
[558] *See* Christian Wimpissinger, Gerritse *Case Addresses Source Taxation as Hindrance*, 31 TAX NOTES INT'L 624, 626 (2003).
[559] Case C-234/01, Gerritse v. Finanzamt Neukölln-Nord, 2003 E.C.R. I-5933.
[560] *Id.* ¶ 24.

resident of the Netherlands earned approximately 6,000 DEM or 10% of his income for performing as a drummer in Berlin.[561] German income tax law distinguished between residents who are allowed to deduct business expenses and nonresidents like Gerritse, who are not allowed to deduct such expenses.[562] Resident taxpayers are taxed on worldwide income at progressive tax rates with a nontaxable threshold of 12,095 DEM, whereas nonresident artists are taxed at a flat 25% rate.[563]

Mr. Gerritse argued that if he were a German resident, he would not have been required to pay taxes on the amount of income earned in Berlin, as it was less than the nontaxable threshold.[564] The German Court referred the matter to the ECJ asking whether the Treaty precludes a German tax law that allows no business deductions and a uniform tax rate applied to nonresidents, whereas residents are able to deduct business expenses and are taxed according to a progressive tax table including a nontaxable threshold amount.[565] Because Gerritse performed services in Germany, the main issue before the Court concerned the freedom to provide services, rather than the freedom of establishment.[566]

With respect to the deductibility of the business expenses, the ECJ ruled that a tax law permitting only residents to deduct business expenses constitutes indirect discrimination on grounds of nationality, contrary to the principles of Articles 59 and 60 (now Arts. 49 and 50) of the EC Treaty.[567] Regarding the different rates of taxation, the Finanzamt and the Finnish Government attempted to justify the difference by arguing that the obligation to consider a taxpayer's personal situation is the responsibility of the State of residence and not the State where the income is generated.[568] The ECJ ruled that although different rates of taxation for residents and nonresidents constitutes indirect discrimination violating Article 60 (now Art. 50),[569] the flat tax rate (in this case 25%) must be compared to the appropriate tax rate in the progressive rate table.[570] In this case, Germany's flat rate was not in violation of Treaty provisions because when the tax-free allowance amount was added to his net income (as he had already received the benefit of a tax-free allowance in his State of residence), Germany would have applied a rate of tax of 26.5% using the progressive rate table.[571] Thus, in this case, the 25% flat rate was not in excess of the rate that would have been applied to a resident using the progressive rate table after factoring in the tax-free allowance.[572] Three cases recently referred to the ECJ further question whether or not a Member State can tax nonresident artists and sportsmen more heavily than resident artists and sportsmen.[573]

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[561] *Id.* ¶ 9-10.
[562] *Id.* ¶ 3.
[563] *Id.* ¶ 3, 8.
[564] *Id.* ¶ 13.
[565] *Id.* ¶ 24.
[566] *Id.* ¶ 23.
[567] *Id.* ¶ 28.
[568] *Id.* ¶ 35.
[569] *Id.* ¶ 53.
[570] *Id.* ¶ 54.
[571] *Id.* ¶ 55.
[572] *Id.*
[573] *Three New Tax Cases Before the ECJ*, Dec. 20, 2004, http://www.allarts.nl/english/articles/2004 (follow "Three New Cases ECJ . . ." hyperlink) (explaining that the ECJ will likely expand on the *Gerritse* decision in the recently referred tax cases of C-290/04 *FKP Scorpio Konzertproduktion*, C-345/04 *Centro Equestro*

3. Analysis

In the area of tax discrimination, both the Supreme Court and the European Court of Justice are engaged in a similar enterprise, balancing well-established tax principles against rights provided by a Constitution or a Treaty. In the American jurisprudence, there appear to be three different tests to be applied depending on which constitutional right is asserted. Matters are further unnecessarily complicated by the fact that corporations may not avail themselves of protection under the Privileges and Immunities Clause. Only individuals may assert this protection; corporations must invoke either the Equal Protection or the Commerce Clause.[574]

In the EU, however, the Treaty requires that corporations must be treated like natural persons. In addition, the case law has evolved to the extent that there is now a uniform approach that is followed with respect to each of the Four Freedoms. In 1995, the Court summarized this approach in the *Gebhard* case:

> It follows, however, from the Court's case-law that national measures liable to hinder or make less attractive the exercise of fundamental freedoms guaranteed by the Treaty must fulfil four conditions: they must be applied in a non-discriminatory manner; they must be justified by imperative requirements in the general interest; they must be suitable for securing the attainment of the objective which they pursue; and they must not go beyond what is necessary in order to attain it.[575]

Thus, the ECJ is applying a very similar test to the Supreme Court's substantial equality test where an individual state must demonstrate a sufficient link between "the legitimate interests served and the discrimination practiced"[576] and that less restrictive alternatives were impractical.[577] The Supreme Court has described this balance as "a rule of substantial equality of treatment" for resident and nonresident taxpayers.[578]

In the jurisprudence of the ECJ, it is settled law that discrimination can arise only through the application of different rules to comparable situations or the application of the same rule to different situations.[579] The ECJ Court has consistently stated since the

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de Leziria Grande Lda. and C-386/04 *Centro di Musicologia Walter Stauffer*, and rule that Member States cannot tax nonresident artists and sportsmen more heavily than resident artists and sportsmen).

[574] TRIBE, *supra* note 44, § 6-37, at 1270.

[575] Case C-55/94, Gebhard v. Consiglio dell'Ordine degli Avvocati e Procuratori di Milano, 1995 E.C.R. I-4165, ¶ 37 (citing Case C-19/92, Kraus v. Land Baden-Wuerttemberg, 1993 E.C.R. I-1663, ¶ 32).

[576] *Id.* "Nothing in the record indicates that non-residents use larger boats or different fishing methods than residents, or that any substantial amount of the State's general funds is devoted to shrimp conservation." Toomer v. Witsell, 334 U.S. 385, 398 (1948).

[577] TRIBE, *supra* note 44, § 6-37, at 1256.

[578] Lunding v. N.Y. Tax App. Trib., 522 U.S. 287, 297 (1998) (citing Austin v. New Hampshire, 420 U.S. 656, 665 (1975)).

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

Schumacker judgment that "[i]n relation to direct taxes, the situations of residents and of non-residents are not, as a rule, comparable."[580] Thus, a Member State's failure to grant certain tax benefits to a nonresident that it grants to a resident is not, as a rule, discriminatory because these two categories of taxpayers are not in a comparable situation.[581]

This analysis resembles the equal protection rational basis test that is used in tax cases.[582] The Equal Protection Clause does not prohibit the states from making reasonable classifications among such persons[583] and "requires only that the classification rationally further a legitimate state interest."[584] The statute will be upheld as long as there is a plausible policy reason for the classification,[585] plausible legislative facts on which a rational legislator could have relied,[586] and "the relationship of the classification to its goal is not so attenuated as to render the distinction arbitrary or irrational."[587] However, unlike the ECJ, the Supreme Court has rarely invalidated state tax laws solely on the basis that they violate the Equal Protection Clause.[588] Legislatures have been given broad latitude in the classifications and distinctions created by tax statutes.[589] But legitimate state interest does not include a state favoring "its own residents by taxing foreign corporations at a higher rate solely because of their residence . . . ."[590] This "constitutes the very sort of parochial discrimination that the Equal Protection Clause was intended to prevent."[591]

This *Schumacker* test appears to function in the simple cross-border employment situation where the workers are earning substantially all of their income from the host state. However, complications such as a spouse earning income in a different Member State, as in *Gschwind*, or a person earning income from multiple Member States, as in *de*

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[580] *See, e.g., id.* ¶ 31.
[581] *Id.* ¶ 34.
[582] Hellerstein, *supra* note 201, at 1332 n.104. *See also* Metro. Life Ins. Co. v. Ward, 470 U.S. 869 (1985) (invalidating Alabama statute that taxed out-of-state insurance companies at a higher rate than domestic companies because the state's purposes were not legitimate to pass the equal protection rational basis test); Wheeling Steel Corp. v. Glander, 337 U.S. 562 (1949) (holding that where a state has permitted a foreign corporation to enter and transact business equal protection must be accorded at least to the extent that their property is entitled to an equally favorable ad valorem tax basis).
[583] *See* Lehnhausen v. Lake Shore Auto Parts Co., 410 U.S. 356, 359-60 (1973) (holding that an Illinois constitutional amendment authorizing ad valorem taxes on personal property of corporations but not with respect to personal property of individuals did not violate the Equal Protection Clause because it was not the result of invidious discrimination and was within the state's discretion to make classifications for tax purposes); *see also* Allied Stores of Ohio v. Bowers, 358 U.S. 522, 526-27 (1959) (holding that an Ohio statute imposing an ad valorem tax on property stored by local companies while exempting out-of-state owners of warehouses did not deny domestic corporations the equal protection of the law).
[584] Nordlinger v. Hahn, 505 U.S. 1, 10 (1992).
[585] *See* United States R.R. Ret. Bd. v. Fritz, 449 U.S. 166, 174, 179 (1980).
[586] *See* Minnesota v. Clover Leaf Creamery Co., 449 U.S. 456, 464 (1981).
[587] *Nordlinger*, 505 U.S. at 11 (citing Cleburne v. Cleburne Living Ctr., Inc., 473 U.S. 432, 446 (1985)).
[588] Zinn & Reed, *supra* note 235, at 92.
[589] Regan v. Taxation with Representation, 461 U.S. 540, 547 (1983). *See also* Madden v. Kentucky, 309 U.S. 83, 88 (1940) (noting that legislatures have the greatest freedom with respect to classifications in the tax area). One exception to this deference exists with respect to interstate business and classifications involving residency usually taking the form of a "domestic preference tax." Zinn & Reed, *supra* note 235, at 92.
[590] Metro. Life Ins. Co. v. Ward, 470 U.S. 869, 878 (1985).
[591] *Id.*

Groot, could cause an individual to be worse off by engaging in cross-border activity. The question to be addressed is how much protection should be guaranteed by the European Union or the United States. Does not a cross-border worker knowingly disadvantage herself every time she works in a State with a higher tax rate than her own?[592] There has to be a balance struck between the encouragement of an Internal Market and the compelling needs of the States and Member States to raise the revenues necessary for their governance.

In the *Danner* case, Advocate General Jacobs states that the ECJ's

> primary task in preliminary rulings is not to decide specific cases on the basis of narrowly distinguished facts, or to solve a problem for the national court in the particular case, but to state clearly and coherently for the benefit of everyone in the Community what the correct understanding of the law is, and to give rulings of general significance.[593]

Unfortunately, although much guidance has been given to the Member States, most of the recent cases are adjudicating very similar issues to those that have been previously decided.[594] The use of a legislative instrument such as a directive would be more efficient in establishing appropriate tax law.

Even though the United States does not have a system of preliminary rulings, Supreme Court opinions serve the same function by providing the state courts with judicial guidance. Thus, it follows that the U.S. Supreme Court should also give rulings of general significance. The *Lunding* majority did not limit their examination to Mr. Lunding's particular fact pattern, which was unsympathetic for the tax year in question since Connecticut had no income tax at that point and Mr. Lunding derived only 48% of his income from New York.[595] The *Lunding* majority was

> not satisfied by the State's argument that it need not consider the impact of disallowing nonresidents a deduction for alimony paid merely because alimony expenses are personal in nature, particularly in light of the inequities that could result when a nonresident with alimony obligations

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[592] Higher tax liabilities that are the result of nondiscriminatory differences in each State's tax rates do not violate the free movement of workers. *See, e.g.,* case C-336/96, Gilly v. Directeur des Services Fiscaux du Bas-Rhin, 1996 E.C.R. I-2793, ¶¶ 30, 47.

[593] Case C-136/00, Danner, 2002 E.C.R. I-8147, Op. ¶ 38.

[594] Jonathan Schwarz, *Personal Taxation Under the European Court of Justice Microscope*, 58 BULL. INT'L FISC. DOC. 12 546, 550 (2004).

[595] Since Connecticut's enactment of an individual income tax in 1992, the concern over under taxation is relieved. Instead, the question becomes an issue of how the personal income tax should be apportioned between New York and Connecticut. After the *Lunding* decision, nonresident payers of alimony will pay less New York tax, which results in a smaller credit against their Connecticut taxes. The nonresident recipient of alimony will only pay tax to Connecticut, as is the case of a former spouse of a New Yorker who now resides in Connecticut. Thus, the current effect of the *Lunding* decision is to shift tax revenues to Connecticut, a decision New York had previously made with respect to the former spouses of New York residents. *See* McIntyre & Pomp, *supra* note 172, for a defense of the New York taxing scheme for alimony.

> derives nearly all of her income from New York, a scenario that may be 'typical' . . . .[596]

The *Lunding* majority also expressed concern about the nonresident who makes payments to a New York resident and the double taxation that would ensue.[597]

The Supreme Court only grants certiorari in about 100 cases of the approximately 7,000 petitions filed per Term.[598] Although the Court's recent denials of certiorari show a lack of enthusiasm for state tax cases,[599] the Court's review is particularly significant in a constitutional challenge to a state tax system in order to send appropriate messages to the state legislatures. Unfortunately when state taxpayers turn to Congress, the result is that no one pays taxes.

VI. Conclusion

The judgments of the European Court of Justice have caused some coordination of various individual and corporate tax laws through negative integration. Pure tax harmonization has not resulted in that a finding of incompatibility of a tax law with a Treaty provision does not guarantee that all Member States will resolve the problem in the same way legislatively.[600] Arguably, this judicial action was necessary during the infancy stage of the Internal Market. However, given the progress made towards the Internal Market, it is time for a more balanced approach that takes into account a Member State's need to finance its government. This could be accomplished through a more judicious use of the rule of reason, on occasion exercising, like the Supreme Court, an extra dose of judicial sympathy for the Member State's taxing power. Alternatively, a European scholar suggests reliance on Article 4 of the EC Treaty. Because this treaty provision obligates the Member States to avoid excessive public deficits, sound tax policies that combat anti-avoidance conduct would need to be accepted as justifications for infringements of the Treaty freedoms.

On the legislative side, the Council is designed to safeguard the economic interests of the Member States. The Finance Minister's acknowledged responsibility is to look after the Member State's interests in tax matters before the Council. The Commission should refocus its energies on formulating Community tax policy, making proposals to the Council, and drafting the detailed measures needed for their implementation. The Commission should continue to push for a move to qualified majority voting for certain tax issues. Hopefully, the Member States will soften their opposition as they experience the frustration that EU enlargement has only exacerbated the inability to have agreement on any new Community tax legislation. At a bare

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[596] Lunding v. N.Y. Tax App. Trib., 522 U.S. 287, 311 (1998).
[597] *Id.*
[598] The Justices' Caseload, *available at* http://www.supremecourtus.gov/about/justicecaseload.pdf (last visited March 23, 2006).
[599] Quirk & Shaver, *supra* note 121, at 650-51 (citing, *e.g.*, Citicorp N. America Inc. v. Franchise Tax Bd., 100 Cal. Rptr. 2d 509 (Cal. Ct. App. 2000), *cert. denied*, 533 U.S. 963 (2001); Kalama Chem., Inc. v. Washington, 9 P.3d 236 (Wash. App. 2000), *cert. denied*, 533 U.S. 931 (2001)).
[600] See *supra* note 430 for a discussion of the different approaches Member States have taken with respect to the finding of incompatibility of CFC legislation.

minimum, the Commission can issue recommendations, which although not legally binding, would be persuasive in pushing Member States towards more tax coordination.

In contrast to my EU recommendation, with respect to the United States, I advocate less congressional involvement. The recent U.S. experience with federal intervention in state tax legislation demonstrates that Congress is being too generous with the states' money. Unlike the Council of Ministers, Congress does not represent the states and there is increasing temptation to enact legislation that benefits a select constituency at a revenue cost to the states. At present, the United States is better off with increased judicial oversight, because in the name of reducing complexity, the congressional answer seems to be that no one should pay taxes. I conclude with a recommendation that the Supreme Court should give priority to state tax conflicts and additional restraints should be placed on the ability of Congress to tamper with state tax laws. I recommend the creation of a Committee of Treasurers patterned after the EU's Economic and Social Committee or the Committee of the Regions but in this case comprised of the treasurers of the fifty states. This Committee of Treasurers would have to be consulted with respect to any federal intervention in state tax legislation.