Common Market Law Review **44:** 1577–1623, 2007.
© 2007 *Kluwer Law International. Printed in the Netherlands.*

DIVIDEND TAXATION IN EUROPE: WHEN THE ECJ MAKES TAX POLICY

MICHAEL J. GRAETZ AND ALVIN C. WARREN, JR.*

1. Introduction

The European Court of Justice has decided more than a hundred cases involving Member States' income tax systems.[1] The vast majority of these decisions hold that national tax legislation violates either the guarantee against discrimination on the basis of nationality or the guarantees of free movement for goods, persons, services and capital found in the EC Treaty.[2] In an earlier article, we analysed the Court's corporate income tax jurisprudence and assessed its potential impact on the economic and political integration of Europe.[3] We concluded that the ECJ is undermining the fiscal autonomy of the Member States by articulating a view of income tax discrimination that is ultimately unstable. That article also argued that the Court's general approach to income tax issues is incoherent because it seeks to eliminate discrimination based on both the origin and destination of economic activity – an impossible quest in the absence of harmonized income tax bases and rates, a situation that does not now exist in the EU and may never exist.[4]

In this article, we examine the ECJ's recent decisions regarding cross-border dividends from the perspective of tax policy. To some Court watchers, this may seem an odd perspective. The ECJ has no explicit charge to make income tax policy, which is generally left to the Member States by the European treaties. Indeed, EU income tax legislation continues to require the unanimous consent of all Member States. All the ECJ can do is decide cases brought to it – usually by the European Commission or on a reference from a national

* Michael J. Graetz is Justus S. Hotchkiss Professor of Law, Yale Law School; Alvin C. Warren, Jr. is Ropes & Gray Professor of Law, Harvard Law School. We are grateful for comments on a previous draft at a Harvard seminar by Malcolm Gammie, Daniel Halperin, Walter Hellerstein, Michael Lang, Richard Lyal, Ruth Mason, Stephen Shay, Otmar Thoemmes, Frans Vanistendael and Richard Vann. The views expressed in this article are, however, those of the authors alone.

1. See generally, Kingston, "A light in the darkness: Recent developments in the ECJ's direct tax jurisprudence", 44 CML Rev., 1321–1359.
2. Arts. 12, 39, 43, 49, 56 EC.
3. Graetz and Warren, "Income tax discrimination and the political and economic integration of Europe", 115 *Yale Law Journal* (2006), 1186.
4. Id. at 1216–19.

court – on the ground that one or more of the freedoms guaranteed by the European treaties has been violated. And, unlike the US Supreme Court, the ECJ has no control over its agenda, as it cannot choose which cases to hear.

Nonetheless, the Court has become deeply enmeshed in fashioning the Member States' income tax policies. As we shall detail, the Court is applying a standard of non-discrimination to evaluate national tax laws in a manner totally divorced from the underlying tax policy norms that produced the legislation at issue. The result is a jurisprudence that fails to hold together substantively, functionally, and rhetorically. In many instances, this result follows from largely formalistic distinctions made by the Court, such as whether a withholding tax on dividends should be considered corporate or shareholder taxation. To be sure, the Court's task is exceptionally difficult. The issues before it have often been found to be intractable by legislatures, so that one can hardly fault a judicial body, with its much more limited mandate, for producing results whose tax policy norms are difficult, if not impossible, to fathom.

To illustrate the overwhelming difficulties that the ECJ confronts in fashioning European income tax policy, we examine in detail the dozen decisions of the Court that set forth its vision of a non-discriminatory system for taxing corporate income distributed as dividends within the European Union. This is an important and rapidly developing area, with half of the decisions handed down since 2006. Cross-border dividends provide a striking example of the difficulties now facing the Court. For a number of reasons, corporate-source income distributed as a dividend to shareholders in the same country as where it originates may bear a lower total tax burden than when distributed as a dividend to shareholders in another country. The ECJ has reacted to this possibility by invalidating tax provisions in either the country in which a dividend is paid or the country in which it is received. The tax policy dilemma facing the Court is that unless it wants to invalidate taxes in both countries, it must choose between eliminating discrimination on the basis of the destination or the origin of corporate investment, but it has no legal basis for making such a choice.

Before turning to the details of the decisions that have placed the ECJ in this dilemma, we need to identify the principal tax policy issues that arise in constructing a system for taxing cross-border dividends and review the standard solutions found in domestic legislation and international tax treaties.

2. Issues in the design of cross-border dividend taxation

We begin by considering seven potentially complicating factors that must be addressed in constructing a system for taxing corporate income and divi-

dends that cross national borders: (i) separate taxation of corporations and shareholders within a single country; (ii) taxation of income to more than one corporation within a single country; (iii) multiple taxation of transnational income by different countries; (iv) different forms of transnational corporate investment; (v) differing conceptions of neutrality and non-discrimination in determining how to tax transnational income; (vi) different resolutions of these issues by a single nation with respect to investments in and from different foreign countries; and (vii) the division among countries of the tax revenue produced by taxing corporate-source income.

The taxation of corporations and their shareholders has long been a vexing problem throughout the world. Income taxes generally apply to both corporations and to individual shareholders. This creates the potential for *economic double taxation* even when the corporation and its shareholders are located within a single country: income may be taxed first to the corporation as it is earned and then again when distributed to individual shareholders as a dividend. Different countries have varied in their responses to this phenomenon, and countries' policies have also varied over time. At one extreme, so-called *classical* tax systems simply permit the resulting double taxation. At the opposite extreme, some countries have integrated their corporate and individual income taxes by providing a full or partial tax credit to shareholders for corporate taxes previously paid with respect to income distributed as a dividend. If all of the corporate tax may be credited by shareholders, this *imputation* of corporate taxes to shareholders would convert the corporate tax into a withholding levy on income ultimately taxed to investors.[5] In order to avoid the possibility of shareholder credits for dividends on which corporate income tax was not previously collected, some imputation systems have required cor-

5. Consider a corporation that earns 100, pays 30 in corporate taxes and distributes half of the remaining 70 to each of its two 50% shareholders, whose individual tax rates are 40% and 20%. Each shareholder is taxed on the gross amount of 50 (cash dividend plus tax credit), subject to a tax credit of 15. As shown in the following table, the corporate levy functions as a withholding tax, in that the corporate income distributed to each shareholder ultimately bears a tax burden determined by that individual's tax rate.

	Shareholder 1	Shareholder 2
1. Tax rate	40%	20%
2. Cash distribution	35	35
3. Tax credit	15	15
4. Taxable amount (2+3)	50	50
5. Gross tax (1x4)	20	10
6. Final Tax (refund) (5–3)	5	(5)
7. After-tax cash (2–6)	30	40
8. Total taxes (3+6)	20	10
9. Effective tax rate (8/4)	40%	20%

porations to pay a *compensatory tax* to make up any shortfall on the payment of a dividend.[6] These compensatory taxes follow from the function of corporate taxation under imputation as withholding of taxes ultimately paid by individual shareholders. As an alternative to using imputation to mitigate or eliminate the burden of economic double taxation, some countries have reduced corporate taxes when income is distributed. More recently, many countries have reduced shareholder taxes by applying a lower rate or partial exclusion for dividends.[7] In terms of domestic tax policy, a country's choice among these options will depend, in part, on its views regarding the economic effects of taxing corporate-source income more heavily than other capital income, compliance burdens of the various alternatives (and who should bear them), and the relationship between corporate and individual tax rates.[8] A key consideration in any form of integration of corporate and shareholder taxes is reduction of differentials in the taxation of equity and debt capital. The latter is generally exempt from economic double taxation, because interest payments are deductible from corporate income.

When one corporation owns shares in another corporation – a common occurrence – the potential exists for triple or even greater taxation of the same economic income. For example, when a corporation holding stock in another corporation receives dividends or sells shares, there is the possibility of taxation to both corporations of the same item of economic income. This we call *multiple corporate taxation*. Many countries have enacted provisions aimed at reducing this phenomenon, including exclusions for intercorporate dividends or gains on the sale of shares, as well as elections allowing consolidation of the income of the corporations and taxing them as a group.[9]

6. If the corporation in the example in the preceding note had paid only 20 in taxes, it would owe 10 more on distribution of the dividend, because the shareholder-credit mechanism assumes that 30 of corporate taxes have been paid for every 70 of cash distributed as a dividend, given a corporate tax rate of 30%.

7. See generally, Vann, "Trends in company/shareholder taxation: single or double taxation?", 88a *Cahiers de droit fiscal international* (2003), 21.

8. For further discussion of the issues involved in designing an integrated tax system, see US Department of the Treasury, "Integration of the Individual and Corporate Tax Systems: Taxing Business Income Once" (1992); Warren, *Integration of the Individual and Corporate Income Taxes*, *Reporter's Study of Corporate Tax Integration* (Am. Law Inst., 1993); and Graetz and Warren, "Integration of Corporate and Individual Income Taxes: An Introduction", 84 *Tax Notes* (1999), 1767. The foregoing are collected in Graetz and Warren (Eds.), *Integration of the U.S. Corporate and Individual Income Taxes: The Treasury Department and American Law Institute Reports* (1998) (hereinafter Treasury and ALI Integration Reports).

9. See e.g. US Internal Revenue Code of 1986 (hereinafter IRC) s. 243 (intercorporate dividend deduction), s. 338(h)(10) (non-taxation on the sale of certain shares by parent companies), and s. 1501 (taxation of affiliated corporations).

When corporate income crosses national borders, there is the additional, and distinct, potential for *international double taxation* (which is sometimes called juridical double taxation). This may arise because both the country in which the income is produced (the *source country*) and the country to which it is distributed (the *residence country* of the distributee) have traditionally asserted jurisdiction to tax. Countries generally reduce or eliminate international double taxation by exempting foreign source income or allowing credits for foreign taxes paid, either as a matter of domestic law or in the bilateral income tax treaties that we describe below.

The potential for multiple corporate taxation, as well as for economic and international double taxation, is further complicated by the different forms of international investments in and by corporations. For example, an individual A, who is a resident of country R, might own stock in company X (also resident in country R), which operates in country S through a wholly-owned subsidiary, company Y, which is a resident in country S. In this case, there are potentially *four* levels of taxation. Country S typically taxes the income of company Y under its income tax. In addition, it may levy a *withholding tax* on the dividend distributions to foreign shareholders, company X in our example. (In spite of being called a withholding tax, this is a final tax, which is generally levied because the non-resident shareholder is not otherwise subject to income taxation in country S.) Subsequently, country R might tax both company X on its income (including dividends it receives from abroad) and shareholder A on his dividend receipts (including dividends paid from income that originated abroad).

Individual A might also own some shares in foreign company. (This is usually called *portfolio* investment to distinguish it from *direct* investment, which occurs when a company sets up a foreign branch or subsidiary.) In this case too, country S could twice tax income that resulted in a dividend to A (once when earned by the corporation and again when distributed to A), depending on its views about economic and international double taxation. Country R would also have the opportunity to tax this income once, when received as a dividend by A.

Other forms of investment are also possible: A might own shares in an investment fund, which then purchases shares in company Y. Alternatively, company X might own only a limited number of shares in company Y (which we call *corporate portfolio* investment). As a result, the factual circumstances and governing legal rules that come before the ECJ are extraordinarily complex and varied. To make our analysis manageable, we will focus primarily on two of the cases illustrated above: direct investments by corporations through majority-owned subsidiaries and portfolio investments by individuals who own less than a controlling interest in a foreign company.

Constructing a neutral (or non-discriminatory) system for taxing dividends from cross-border investment is thus complicated by the issues mentioned above (economic or international double taxation, multiple taxation and long-standing differences in treatment of direct and portfolio investment by individuals and corporations). Those difficulties are further compounded by the lack of agreement regarding the concept of neutrality that should guide the design of such a system.

The two principal competing views of tax neutrality can be framed in terms of source and residence countries (S and R in our example). Under the first concept – *capital import neutrality* – all economic activity within a single country (S) should bear the same tax burden, whether the capital used in income production is domestic or foreign. Under the second concept – *capital export neutrality* – all income earned by the residents of a single country should bear the same tax burden, whether the income is earned at home or abroad.[10]

The usual rationale for capital export neutrality is that worldwide economic welfare will be maximized if locational choices (such as whether X invests in country R or S) are not affected by taxation. From this perspective, residence, but not source, countries should tax income. The usual rationale for capital import neutrality is that it increases economic welfare by encouraging the most efficient use of resources within a country. From this perspective, source, but not residence, countries should tax income. Economists have tended to favour capital export neutrality, while corporate managers have tended to favour capital import neutrality.

It is now recognized that the two forms of neutrality cannot be achieved simultaneously unless tax rates and bases are identical in source and residence countries.[11] The tax systems of many countries reflect both principles. For example, the US taxes US companies on a world-wide basis, subject to a

10. A third concept, sometimes called "national neutrality," argues for a deduction for foreign taxes, rather than a credit or exemption, to alleviate international double taxation. The key idea here is that domestic and foreign taxes are different because a country benefits only from the taxes it collects. For further discussion of these concepts, see US Congress, Joint Committee on Taxation, "Factors Affecting the International Competitiveness of the United States" (JCS-6–91,1991), 236–248. See also Desai and Hines, "Evaluating international tax reform", 56 *National Tax Journal* (2003), 487, arguing for "capital ownership neutrality" and "national ownership neutrality" as new benchmarks for evaluating the desirability of international tax reforms; but see Kane, "Ownership neutrality, ownership distortions, and international tax welfare benchmarks", 26 *Virginia Tax Review* (2006), 53, arguing that those benchmarks do not necessarily promote global and national welfare.

11. For more on capital export and import neutrality, as well as a critical evaluation of the role these concepts play in the analysis of international taxation, see Graetz, "Taxing international income: Inadequate principles, outdated concepts, and unsatisfactory policies", 54 *Tax Law Review* (2001), 261.

foreign tax credit, which generally promotes capital export neutrality. On the other hand, the income of foreign subsidiaries of US corporations is not generally taxed until it is repatriated to the US, which promotes capital import neutrality in the interim.

The tax law of many industrialized countries is therefore often described as a compromise between capital import and capital export neutrality. However, the nature of that compromise, as reflected in the detailed rules of taxation, not only varies among countries, but also within a single country over time. In addition, such national legislation is regularly modified by bilateral tax treaties, in which the two signatory nations agree to a particular tax regime, including the treatment of cross-border dividends, that is part of some broader package of mutually beneficial concessions. It is therefore entirely possible that country S will treat dividends paid to country R differently from dividends paid to a third country T. And country R may well treat dividends received from country S differently from dividends received from country T.

Finally, in addition to accounting for all these differences, designing a system of income taxation of cross-border dividends must also recognize that the law will effectively divide revenues among nations. What is at stake here is not simply the effect of non-neutralities on taxpayers but also the allocation of tax revenues between national treasuries. For example, even if all tax rates and bases were the same, so that capital export neutrality and capital import neutrality could be achieved simultaneously, the choice between residence and source taxation would still crucially determine which country receives the revenue from which investments.

These difficulties in international tax policy can be illustrated by a question that occurs in many of the ECJ cases discussed below: how should an integrated corporate-shareholder tax system deal with cross-border dividends?[12] The issue arises in two contexts: how should a source country treat foreign shareholders and how should a residence country treat corporate taxes paid abroad? If an imputation source country fails to grant shareholder credits to foreign shareholders on outgoing dividends, incoming investment might bear a heavier tax burden than domestic investment. Similarly, if an imputation residence country fails to grant shareholder credits for taxes paid abroad on foreign corporate-source income, outgoing investment could be taxed more heavily than domestic investment. As a matter of national tax policy, the gen-

12. See generally Harris, *Corporate/shareholder Income Taxation and Allocating Taxing Rights between Countries* (1996); Treasury and ALI Integration Reports, *supra* note 8, at 12–14, 183–98, 735–63; Ault, "Corporate integration, tax treaties and the division of the international tax base: Principles and practices", 47 *Tax Law Review* (1992), 565; Ault, "International issues in corporate tax integration", 10 Law & Pol'y Int'l Bus. (1978), 461.

eral tendency around the world has been either not to grant credits for outbound and inbound dividends or to grant them only through bilateral treaties. Failing to allow shareholder credits either for dividends paid to foreigners or for corporate taxes paid abroad tends to favour domestic investment over foreign investment, and, as a tax policy matter, this is where most countries have landed as an initial matter.

Extending credits to outgoing dividends would tend to promote capital import neutrality and reduce tax revenues of source countries. Extending credits to incoming dividends would tend to promote capital export neutrality and reduce tax revenues of residence countries. The first approach would reduce differences in treatment based on the origin of capital, while the second would reduce differences in treatment based on its destination.

The choice between these two approaches is certainly not obvious, and studies commissioned by the European Commission have sometimes recommended the first and sometimes the second.[13] Both approaches, however, cannot be implemented simultaneously unless the goal is not just to eliminate discrimination against cross-border income, but to tax international income *more favourably* than domestic income.[14]As we shall see, the ECJ's tax decisions have required the Court to resolve the dilemma presented by this choice, but do not offer any coherent rationale for choosing between the two approaches. Before turning to those decisions, we need to explain how the international tax system has responded to the complexities of taxing cross-border dividends, because that response has been invoked to justify some of the Court's recent decisions.

13. See e.g. EC Commission, Segré Report: The Development of a European Capital Market (Nov. 1966), 301–302, 311–312, recommending imputation credits be extended to outgoing dividends; Commission, Report of the Committee of Independent Experts on Company Taxation, Ruding Committee Report (March 1992), recommending staged steps to reduce corporate tax distortions, including a minimum base and rate, as well as extension of imputation credits to incoming dividends. For other Commission studies recommending other unified systems of corporate taxation for Europe, see Commission Proposal for a Council Directive Concerning the Harmonization of Systems of Company Taxation and of Withholding Taxes on Dividends, O.J. 1975, C 253/2 (recommending a common imputation system); Van den Tempel, "Corporation Tax and Individual Income Tax in the European Communities" (Commission, Approximation of Legislation Series No. 15, 1970) (Van den Tempel Report), recommending a common system of separate corporate and individual income taxation; Commission, The Development of a European Capital Market; Commission, Fiscal and Fin. Comm., Report on Tax Harmonization in the Common Market (Neumark Report) (July 8, 1962), reprinted in Tax Harmonization in the Common Market 7 (Commerce Clearing House, Inc. ed. & trans. 1963), recommending a common system of split-rate corporate taxation under which preferential rates would apply to distributed earnings.

14. See e.g. the example in note 71, *infra*.

3. The approach of the international tax system

3.1. *A brief outline of the international tax system*

As a matter of jurisdiction, an important distinction arises between source and residence countries in international taxation. A source country may tax income arising within that country, while a residence country may tax its residents on domestic and foreign income, subject to relief for international double taxation. In any single nation, which can be both a source and residence country, this translates into an important difference between the taxation of residents (potentially on world-wide income) and non-residents (on local income only).[15] Although fundamental to the international tax system, this distinction turns out to carry little weight with the ECJ in the cases we discuss below.

Over the last eighty years, an international system for the taxation of cross-border income has evolved in more than two thousand bilateral tax treaties. While there are important differences, those treaties are generally based on the model developed by the Organization for Economic Cooperation and Development (OECD).[16] As applied to corporate-source income, the international tax system comprises three key elements: the treaty provisions specifically devoted to the reduction of international double taxation, the effect of other treaty provisions, and the impact of tax planning by multinational corporations. In general, source countries agree in bilateral tax treaties to mutual reduction of source-country withholding taxes on dividends paid to foreign shareholders.[17] In the case of dividends to corporate parent companies, the withholding tax may be reduced to zero. Residence countries agree to mitigate international double taxation either by exempting foreign income or by providing a tax credit for taxes paid to the source country.[18] This foreign tax credit is generally limited to the tax due in the residence country, so that residence countries do not have to refund taxes paid to another nation.[19] In the case of direct investment, if certain ownership thresholds are met, an *indirect* foreign tax credit is allowed for taxes paid by foreign subsidiaries or sub-subsidiaries, when the taxed income is distributed to the parent company as a

15. The US is atypical in that it taxes its citizens on their world-wide income even if they are not resident in the US.

16. OECD, Model Tax Convention on Income and on Capital (2005 revision) (hereinafter OECD MTC).

17. See e.g. OECD MTC, Art. 10(2).

18. See e.g. OECD MTC, Arts. 23A and 23B.

19. See e.g. IRC s. 904 (limitation on foreign tax credit).

dividend.[20] (The *foreign* tax credit is distinct from the *imputation shareholder* tax credit described earlier, but, as we shall see, cross-border dividends can create an interaction between the two.)

The net result of these treaty concessions is often described as granting the corporate tax base exclusively or primarily to the source country and the investor tax base exclusively or primarily to the residence country.[21] In terms of the first example above (direct investment), country S would levy only one level of tax (on Y's corporate income), if it eliminated withholding on the dividends paid to the parent company X. Country R would either exempt X's dividend receipts from Y or provide a credit for the taxes paid by Y to country S. Whether or not the income originating in country S would be taxed again when distributed as a dividend to shareholder A would depend on how country R's tax law dealt with economic double taxation – whether it had integrated its corporate and individual income taxes – and, if it had integrated, how it dealt with taxes paid to another country. In the second example (portfolio investment), country S would also levy a tax on corporate income in S, but any foreign tax credit provided by country R would be limited to withholding taxes on dividends received by A.

While the preceding paragraph is accurate, it is not a complete account of the division of the tax base between source and residence countries, because it fails to reflect the other tax treaty provisions affecting that division. Consider first the level of penetration into the economy of the source country required before that country can assert jurisdiction to tax under tax treaties. In the conventional language of international taxation, the activity of non-residents must generally rise to the level of a *permanent establishment* before business income can be taxed by the source country.[22] (Most permanent establishments are *branches* of foreign companies, and we use the two terms interchangeably.) The permanent establishment threshold is hardly self-defining and is sometimes controversial, but if it is not met, the corporate tax base belongs to the residence country.

Next consider the deductibility of certain payments, such as royalties. If company X in our example has provided technology to its foreign subsidi-

20. See e.g. IRC s. 902.

21. E.g. Graetz and O'Hear, "The 'Original Intent' of U.S. International Taxation", 46 Duke L.J. (1997), 1021; see also Bird and Scott Wilkie, "Source- vs. residence-based taxation in the European Union: The wrong question?", in Cnossen (Ed.), *Taxing Capital Income in The European Union* (2000) p. 78, arguing that source and residence are not particularly useful principles for assigning tax jurisdiction.

22. See e.g. OECD MTC, Arts. 5 and 7. For more on the level of penetration necessary to trigger taxation in seven developed countries, see Ault and Arnold, *Comparative Income Taxation: A Structural Analysis*, 2nd ed. (2004), pp. 395–397.

ary Y, for which Y pays X a royalty, that royalty will generally be deducted from Y's income and included as X's income. Thus, if taxed at all, this portion of Y's income will be taxed in country R, rather than country S, except to the extent S imposes a withholding tax on outgoing royalties.[23] Similarly, to the extent X capitalized Y with debt, rather than equity, deductible interest payment would result in Y's production in S being taxed in R, rather than S. Intercompany sales may also allow shifting of income between countries through the prices agreed to by related parties. Under the standard treaty provisions, such *transfer prices* must approximate the arm's length prices that would be charged in a transaction between unrelated parties.[24] But, it is often difficult, if not impossible, to identify just what such a price would be when the only observed transfers are between related entities, which is often the case for transfers of technology and other intangible assets.

Treaty provisions affecting individual portfolio investment may also affect the division of the tax base between source and residence countries. A's capital gains on sale of his stock in company Y will, for example, generally be taxed in A's country of residence, not country S, where Y is organized and earns its income.[25]

Finally, consider the usual tax treaty provision that requires non-discrimination against foreigners.[26] This turns out to be a relatively narrow prohibition, which applies only to incoming investment in source countries.[27] Accordingly, the tax treaties' requirement of non-discrimination does not constrain how a country taxes either domestic or foreign investment of its own residents. There is thus nothing in the tax treaties that prevents imputation residence countries from denying individual shareholder credits to incoming dividends. Moreover, the general international distinction between the taxation of residents (which can extend to worldwide income) and nonresidents (which is limited to income arising in the source country) has meant that imputation source countries are also free to deny shareholder credits to outgoing dividends paid to foreigners.

Tax planning by corporations can further affect the division of the tax base among countries.[28] Company X, for example, might prefer that the income produced by its subsidiary Y in country S be taxed in country H, a tax haven

23. See e.g. OECD MTC, Art. 12.
24. See e.g. OECD MTC, Art. 9.
25. See e.g. OECD MTC, Art. 13.
26. See e.g. OECD MTC, Art. 24.
27. For a more detailed analysis of these provisions, see Warren, "Income tax discrimination against international commerce", 54 *Tax Law Review* (2000), 131.
28. See e.g. Vann, *Division of the International Tax Base*, (manuscript, 2007) (discussing structural flaws in the current transfer pricing rules); Arnold, Sasseville and Zolt (Eds.), *The*

with very low rates. X might therefore cause Y to be organized in country H and to use a business structure in country S that does not rise to the level of a permanent establishment. Whether this plan will succeed will depend on the law of country S as well as the anti-avoidance provisions applied by country R (and its tax treaties) to company X.[29]

Multinational companies often engage in tax planning to avoid paying taxes in either the source or residence country. Consider again deductible payments of royalties from subsidiary Y to its parent company X. In principle, the foreign tax credit in country R should be limited to country S withholding (if any), because no other taxes have been paid on this income in country S. However, some nations, including the US, permit high and low-taxed foreign income to be mixed together before the application of the tax credit limitation. Company X therefore may repatriate income from another subsidiary in a high-tax jurisdiction and use the resulting excess foreign tax credits to offset any country R tax on the income originating in country S.[30] This possibility has led numerous commentators to suggest that many American companies would experience a tax *increase* if the US substituted an exemption of foreign-source dividends for its current foreign tax credit.[31]

Taxation of Business Profits Under Tax Treaties (2003) (papers discussing how the tax treaties should respond to modern business practices).

29. See e.g. IRC Subpart F (providing for current taxation of certain controlled foreign subsidiaries of US companies).

30. Suppose the tax rate is 30% in country R, 40% in country S-1, and 20% in country S-2. Company X, which is based in R, earns 100 in both S-1 and S-2. The after-tax earnings are then repatriated to X's headquarters in R, which taxes foreign income subject to a foreign tax credit. If considered separately, the 60 from S-1 should produce no R tax because the 100 of income has already borne a higher tax in S-1 than is applicable in R. On the other hand, the 80 from S-2 should produce tax of 10 in R because the S-2 income was taxed at only 20%, which is lower than the 30% rate applicable in R. If, however, the foreign income is mixed together, the result is 200 of income that has borne foreign taxes of 60, for an overall rate of 30%, so no additional tax is due in R. These results are summarized in the chart below:

	S-1	S-2.	Combined
1. Income	100	100	200
2. Foreign tax	40	20	60
3. Cash dividend (1–2)	60	80	140
4. R taxable income (3+2)	100	100	200
5. R tentative tax (30% of 4)	30	30	60
6. R foreign tax credit	30(a)	20	60
7. R final tax (5–6)	0	10	0

(a) 40 foreign tax credit limited to R domestic tax of 30

31. See e.g. President's Advisory Panel on Federal Tax Reform, "Simple, Fair and Pro-Growth: Proposals to Fix America's Tax System" (2005) 104, 132–135; Lokken, "Territorial taxation: Why some US multinationals may be less than enthusiastic about the idea (and some ideas they really dislike), 59 *Southern Methodist Law Review* (2006), 751; US Congressional Budget Office, Revenue Options (February 2007).

3.2. *The approach of the international tax system to inherent complexities*

Given this brief sketch of the international tax system, we can now return to the seven complexities inherent in the taxation of cross-border dividends described above and summarize how international tax policy has responded to them:

(i) Countries are not constrained in their response to the possibility of domestic economic double taxation. They are free to adopt their own variants of classical or integrated systems and to choose the scope of imputation or dividend exclusion systems.

(ii) Countries are not constrained in their response to the possibility of domestic multiple corporate taxation. They are, for example, free to adopt (or not) group taxation or exclusions for intercorporate dividends.

(iii) Countries are not constrained in their choice between exemption and credit systems as a response to the potential for international double taxation. They may (or may not) provide equivalent benefits for cross-border and domestic dividends. In particular, imputation countries are free to deny shareholder credits to incoming or outgoing dividends.

(iv) There has been no comprehensive attempt to harmonize the results across various forms of international investment, such as whether foreign shares are held by individuals or companies.

(v) Countries are not constrained in their choice among capital import neutrality, capital export neutrality, some combination thereof, or some other form of neutrality.[32]

(vi) Countries are free to resolve the foregoing issues differently with different trading partners through differing bilateral tax treaties. While similar treatment of trading partners is nonetheless common, the celebrated "most favoured nation" clause found in trade treaties is not an essential part of the international tax treaty network.[33]

(vii) The actual division among countries of the tax base for transnational corporate-source income will vary not only with domestic law and bilateral tax treaties, but also in accordance with the business, financial and remittance structures employed by multinational corporations.

32. The requirement of the OECD model treaty that residence countries grant either an exemption or a credit to eliminate double taxation of foreign income would preclude the deduction for foreign taxes suggested by the concept called national neutrality. See note 10 *supra*; OECD MTC Arts. 23A and 23B.

33. There are some 400 MFN clauses in the more than 2000 bilateral tax treaties. See Hofbauer, *Das Prinzip der Meistbegünstigung im grenzüberschreitenden Ertragsteuerrecht: eine Betrachtung anhand des Internationalen Wirtschaftsrechts und des Rechts der Doppelbesteuerungsabkommen* (Linde, 2005).

In light of the ECJ decisions discussed below, it is worth repeating that these results depend not only on each country's domestic law and its bilateral tax treaty provisions dealing explicitly with international double taxation, but also on other provisions of the treaties, such as the definition of a permanent establishment, as well as tax planning by multinational companies.

This then is the broad tax policy context in which the ECJ is operating when it decides cases involving cross-border dividends. Different countries around the world, including those in Europe, have resolved these issues differently and even within a single country these issues have been resolved differently at different times.[34]

4. The decisions of the European Court of Justice

Before we analyse the approach that the ECJ has taken to the taxation of cross-border dividends, a few introductory comments are in order. First, as we have written previously, the key inquiry in these cases is whether cross-border transactions are subject to more onerous tax treatment than purely domestic transactions.[35] We accordingly focus on whether and why the Court finds such *discrimination*, irrespective of the fundamental freedom or Treaty article on which it relies for the finding.[36] Nor do we distinguish here among the doctrinal categories the ECJ assigns to offences (such as restriction or discrimination) or to defences (such as cohesion or proportionality).[37]

34. E.g.: a 1991 US Treasury report recommending integration of corporate and individual taxes concluded that taxes paid to foreign countries should not be credited when dividends are paid to individual shareholders, except in return for concessions in bilateral tax treaties. That report pointed out that granting such credits unilaterally would cost about $ 17 billion of revenue (or 19% of total corporate taxes) in 1992. A subsequent Treasury proposal later that same year reversed course and urged that such credits be allowed, presumably to attract support for the proposal from US multinationals. Compare Report of the Department of Treasury on Integration of the Individual and Corporate Tax Systems: Taxing Business Income Once (January 1992) with Department of the Treasury, A Recommendation for Integration of the Individual and Corporate Tax Systems (December 1992). More recently, a 2005 Presidential Panel on tax reform urged that the benefits of integration should be limited to dividends from US companies that had paid US taxes, a restriction not adopted by Congress when it enacted a dividend exclusion provision in 2003. Compare President's Advisory Panel on Federal Tax Reform, supra note 31, at 124–126 with IRC s. 1(h)(11).

35. See Graetz and Warren, *supra* note 3.

36. See also Lyal, "Non-discrimination and direct tax in Community Law", 12 *EC Tax Review* (2003), 68 (arguing that the ECJ income tax decisions could generally be analysed as discrimination cases). Mr Lyal was the Commission's representative before the ECJ in most of the cases discussed in this article.

37. For a discussion of these defences by doctrinal category, see Mason, *Primer on Direct Taxation in the European Union*, (2005) pp. 93–114. See also Snell, "Non-discriminatory tax

Second, although the Council has the power to legislate (by *directive*) regarding income taxation in the EU, there are very few such directives, because tax legislation is subject to a veto by any Member State. The only legislation directly relevant to the taxation of dividends is the Parent-Subsidiary Directive concerning dividends paid by subsidiaries in one Member State to parent companies in another Member State.[38] That Directive requires source countries to eliminate withholding taxes on outgoing dividends from a subsidiary to a parent company, while resident countries are required to exempt incoming dividends from subsidiary to parent companies or to grant a tax credit for taxes paid by the subsidiary in the source country.

Finally, several of the ECJ cases deal with European imputation systems that have since been replaced with dividend exclusions. We think that replacement makes these decisions more, rather than less, important, in considering the ECJ's effect on tax policy, because the Court's jurisprudence was a primary factor leading Member States to abandon their imputation systems as a means of mitigating economic double taxation.[39]

We now turn to an analysis of the ECJ decisions concerning the taxation of dividends. To date, there have been a dozen such decisions involving both inbound and outbound dividends, half of which have been handed down since 2006. Cases involving inbound dividends arise in residence countries and concern the possibility of discrimination based on the destination of investment. Cases on outbound dividends arise in source countries and concern the possibility of discrimination based on the origin of investment. In the conventional language of international taxation, inbound dividends raise questions of capital export neutrality, while outbound dividends raise questions of capital import neutrality.

In order to facilitate the discussion, we have organized the decisions into four categories. We begin with (1) the two earliest cases, both of which involved dividends received by permanent establishments. We then consider (2)

obstacles in Community Law", 56 ICLQ (2007), 339 (arguing that the ECJ focuses on discrimination in tax cases, applying a narrower test than in regulatory cases); Kingston, op. cit. *supra* note 1 (arguing that the ECJ has moved away from restriction and towards discrimination analysis in tax cases).

38. As originally enacted in 1990, the Directive applied to parent companies that owned 25 % of a subsidiary, but that percentage has been reduced to 15% and will decline to 10% in 2009. Council Directive of 23 July 1990 on the common system of taxation applicable to parent companies and their subsidiaries in different Member States (90/435/EEC); Council Directive 2003/123/EC of 22 Dec. 2003 amending Directive 90/435/EEC on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States. The 2003 directive also mandated an indirect foreign tax credit in residence countries using a foreign tax credit.

39. For more on this point, see Graetz and Warren, *supra* note 3, at 1208–1212.

dividends received by individual shareholders under tax legislation designed to reduce economic double taxation, (3) cross-border dividends paid to corporations under imputation systems, and (4) withholding taxes on cross-border dividends. Readers unfamiliar with these cases may find the chart in the Appendix useful. It is worth recalling that the foreign countries in the decisions discussed below are, unless otherwise indicated, other EU Member States.[40]

4.1. *The early cases*

Commission v. *French Republic* (*Avoir Fiscal*),[41] decided in 1986, was one of the earliest ECJ cases dealing with income taxation. At issue was the shareholder credit under the French imputation system. Under French law, that credit, or *avoir fiscal*, was available for dividends paid by French corporations to French insurance companies or to their French subsidiaries, but not for dividends paid by French corporations to French branches of foreign insurance companies. France argued that the distinction should be upheld for two reasons: first, non-residents are not in the same position as residents for tax purposes and, in any event, benefit from other tax advantages not available to residents. Second, the allocation of taxation should be left to the bilateral tax treaties. France generally applies the territorial system described above to eliminate international double taxation by exempting foreign business income earned by French companies. Since both French companies and French branches of foreign companies were therefore taxed only on French-source income, the ECJ found in the *Avoir Fiscal* case that it was discriminatory to deny the latter credits available to the former. It further held that any offsetting tax advantages under French law to non-residents were not relevant to that determination. Nor, according to the Court, were the tax treaties relevant to the treatment of this item of domestic income, since the dividends originated in the same country in which the branch operated.[42]

40. We do not discuss in this article the implications of these decisions for companies established outside the EU, which has been a matter of considerable interest. See e.g. Case C-492/04, *Lasartec Geselischaft fur Stanzformen mbH* v. *Finanzamt Emmendingen*, judgment of 10 May 2007, nyr (freedom of establishment does not extend to non-member countries); Case C-157/05, *Holbock* v. *Finanzamt Salzburg-Land*, judgment of 24 May 2007, nyr (freedom of movement of capital is applicable to incoming dividends from a non-Member State, but the residence country legislation was subject to a grandfather clause in the EC Treaty); Cordewener, Kofler and Schindler, "Free movement of capital: Third country relationships and national law: An emerging issue before the ECJ", 47 ET (2007), 107; Lang and Pistone (Eds.), *The EU and Third Countries*: *Direct Taxation* (2007, Linde).

41. Case C-270/83, *Commission* v. *French Republic* (*Avoir Fiscal*) [1986] ECR 273.

42. While not litigated, it is worth noting that this kind of disadvantage to a branch of a

The ECJ did not decide another dividend case until 1997. That case, *Compagnie de Saint Gobain v. Finanzamt Aachen-Innenstadt*, involved German taxation of a branch of a French company.[43] Germany denied such permanent establishments two tax advantages that were available to German companies when they received foreign dividends: an exemption for dividends received from non-EU countries under a bilateral tax treaty and an indirect foreign tax credit for taxes paid by a foreign subsidiary.[44] Germany argued that these provisions were not discriminatory for several reasons. First, residence companies were taxed differently from non-residents in that Germany taxed the former on their world-wide income (subject to foreign tax credits), while it taxed the latter only on their German income. Second, the tax concessions to a German company on its receipt of dividends from abroad could be made up by German taxation of that company's dividends to its shareholders, but neither future remittances by a German branch to its French headquarters company nor dividends paid by that company would be subject to taxation in Germany. Third, the income at issue here was foreign income, so the division of tax base in Germany's tax treaties should be respected.

The ECJ rejected the first argument on the grounds that domestic companies and branches of foreign companies were in the same position for these purposes, as Germany taxed both on dividends received. It rejected the second argument on the grounds that other advantages of non-resident taxation could not be used to justify this disadvantage. Germany's final argument was rejected with a rhetorical opposition that is found in many of the Court's decisions: the Member States are free to use bilateral tax treaties to *allocate* taxing power, but once allocated, the *exercise* of allocated power must not be discriminatory.[45] These tax concessions granted by Germany to German companies therefore had to be extended to German branches of foreign companies to be compatible with the EC Treaty.[46] According to the Court,

foreign corporation might have also been subject to challenge under the standard non-discrimination clause of bilateral tax treaties, unless the treaty explicitly permitted this treatment. The ECJ in *Avoir Fiscal* also concluded that the fact that the advantage sought could be garnered by organizing the branch operations as a French subsidiary did not justify the discrimination against a branch, since the freedom of establishment allows non-residents to choose any legal form they desire.

43. Case C-307/97, *Compagnie de Saint Gobain* v. *Finanzamt Aachen-Innenstadt* [1999] ECR I-6161.

44. The case also involved the exemption of certain foreign holdings for purposes of a capital tax.

45. *Saint Gobain*, *supra* note 43, paras. 56–57.

46. Ibid., para 58.

mandating Germany's unilateral extension of these tax advantages would not affect the rights of Germany's non-EU treaty partners.[47]

As illustrated by these two decisions, a holding of discriminatory income taxation by the ECJ typically involves three steps: (1) finding that domestic and foreign taxpayers are in comparable positions, (2) finding that there is a difference in tax treatment, and (3) finding that other differences between domestic and foreign taxpayers are irrelevant. This methodology has been called the "comparable internal situation test."[48] Since both step (1) and step (3) involve attributes of domestic and foreign taxpayers, the Court's methodology, in order to be persuasive, has to provide a defensible rationale for assigning some attributes to the first category and others to the third. That rationale should be related to the purpose of the non-discrimination requirement, which is presumably to prevent Member States from using their tax legislation to favour domestic commerce over commerce among Member States.

Within this framework, the results in *Avoir Fiscal* and *Saint-Gobain* depend on two key assumptions: first, that the appropriate comparison in step (1) was with a domestic company that received the same dividends as the branch of the foreign company, and second, that the only relevant transaction was the receipt of those dividends. If, on the other hand, the Court had conceptualized the relevant transaction as the stream of corporate income from subsidiary to parent company and then on to individual shareholders, it might have concluded that the domestic company was *not* comparable to the foreign branch, because the end of the stream (dividends from each parent company to its shareholders) was taxable by the litigating country only in the case of the domestic company. Germany made precisely this argument in *Saint-Gobain.* The Court responded by saying that *other* advantages for the foreign branch could not offset the litigated disadvantages. This, however, is circular reasoning: such advantages are *other* only if they are in category (3), rather than (1). The Court offers no explanation whatsoever for its decision to restrict the framework for its analysis of non-discrimination to the dividend receipt, rather than looking to the entire stream of corporate-source income flowing ultimately to the shareholders. (Indeed, it is the latter that is typically regarded as relevant by a national government in fashioning its tax policy.) The Court thus fails to provide any rationale for its conclusion that the non-taxability of distributions by the branch to its foreign parent is irrelevant, rather than highly relevant, to the comparison with a domestic company. Unfortunately, the Court's failure to explain why it assigns some attributes to

47. Ibid., para 59.

48. Mason, "Flunking the ECJ's discrimination test", 46 Col. J. Trans. Law (forthcoming, 2007).

category (1) and others to category (3) turns out to be a recurring defect in the ECJ income tax decisions.[49]

These two early cases show that from the beginning, the Court has sought to eliminate discrimination for both inbound and outbound dividends. We now turn to how the Court has approached that enterprise for dividends received by individuals.

4.2. *Dividends received by individuals*

4.2.1. *Inbound dividends*

The ECJ has decided four cases involving foreign dividends received by individuals under tax systems designed to reduce economic double taxation. In each case, the Court held that the treatment of foreign dividends had to be conformed to that of domestic dividends to satisfy the EC Treaty.

The first such decision, *Verkooijen*,[50] involved a simple dividend exclusion. The Netherlands allowed individuals an exemption for a limited amount of dividends received from Dutch companies (on which a Dutch "dividend tax" had been withheld), but no such exclusion for dividends from foreign companies (which had not borne Dutch withholding.) According to the Court, the Dutch legislation was intended to reduce economic double taxation of corporations and their shareholders and to encourage investment in Dutch shares. The ECJ held that limiting the exclusion to dividends from domestic companies was a violation of the EC Treaty because it had "the effect of dissuading" Dutch investors from buying stock of companies in other Member States and was an obstacle to the raising of capital in the Netherlands by such companies.[51] These conclusions about causality are obviously incomplete, in that any such consequences must be the cumulative result of the tax situation in *both* the source and residence countries. In response to the Netherlands' argument that its exemption should not apply to foreign dividends because its purpose was to reduce economic double taxation in the Netherlands, the Court responded that there was no "direct link" between the corporate and shareholder taxes, which it described as "two separate taxes levied on different taxpayers."[52]

49. Cf. Mason, ibid., (concluding that the ECJ's reasoning was circular in a sample of ECJ decisions involving income taxation generally).

50. Case C-35/98, *Staatssecretaris van Financiën* v. *B.G.M. Verkooijen*, [2000] ECR I-4071.

51. Ibid., at paras. 34–35. The Court relied on the Directive that implemented the Treaty guarantee of freedom of movement for capital during the relevant period, European Council Directive 88/361/EEC of 24 June 1988 for the implementation of Article 67 of the Treaty, O.J. 1988, L 178/5–18.

52. *Verkooijen*, *supra* note 50, para 58.

Given the long history of various approaches to economic and international double taxation of corporate-source income described above, this response is astonishing. Under the Court's approach, the Dutch legislation is to be tested for discrimination by looking only at the taxation of shareholders, with the taxation of the distributing corporation's income flow completely ignored. Put differently, in setting its level of shareholder taxes, the Netherlands is not entitled to consider whether it collects taxes on the income stream at the corporate level, even though the corporate taxes might have been levied in lieu of shareholder taxes. The ECJ offers no reason for classifying this inquiry as irrelevant (category (3) in our description of the Court's methodology), other than its assertion that corporations and shareholders are different taxpayers. We would have thought that a careful inquiry into the relative tax burdens on domestic and cross-border income streams would at least begin by looking at the totality of taxes on each stream.[53]

The second case in this group, *Anneliese Lenz v. Finanzlandesdirektion für Tirol*,[54] concerned Austrian legislation providing that dividends received by individuals from domestic companies could either be taxed at a 25 percent flat rate or, if subject to graduated rates, benefit from a rate reduction. These benefits did not depend on Austrian corporate taxes actually having been paid. Dividends from foreign companies were subject to taxation at the usual graduated rates, up to a 50 percent maximum. As in *Verkooijen*, the Court reasoned that such a provision had "the effect of deterring" Austrians from buying foreign shares and made raising equity in Austria less attractive for foreign companies than raising equity at home.[55] As indicated above, however, cross-border tax incentives to invest at home or abroad must depend on the corporate and shareholder tax situations in both countries. But the ECJ held that the tax rate abroad was irrelevant because "other tax advantages" could not offset the litigated disadvantages.[56] As for considering the flow of corporate income, the Court simply repeated that corporate and shareholder taxes are "two distinct taxes which affect different taxpayers."[57]

In response to Austria's argument that its method of relieving economic double taxation should not apply to foreign companies from which no Austrian tax had been collected, the ECJ stated that both Austrian and foreign companies might be subject to double taxation, so Austria could not treat

53. See e.g. Bond, Gammie, Mokkas, *Corporate Incomes Taxes in the EU: An Economic Assessment of the Role of the ECJ* (manuscript 2006) (arguing that the tax treatment that matters for investors is the overall combination of source-country and residence-country treatment).

54. Case C-315/02, *Anneliese Lenz* v. *Finanzlandesdirektion für Tirol*, [2004] ECR I-7063.

55. Ibid., paras. 20–21.

56. Ibid., paras. 41–43.

57. Ibid., para 36.

them differently. In other words, Austria was prohibited from taking into account whether another country had collected the tax revenue on the corporation's income in designing its system for taxing corporate income distributed to shareholders as dividends, at least where relief for domestic dividends did not depend on payment of a corporate tax. According to the Court, extending lower rates to dividends from *foreign* companies would not interfere with Austria's goal of reducing double taxation on *domestic* corporate income.[58]

To return to the Court's discrimination methodology, dividends from a company organized in another Member State were compared in *Lenz* with dividends from a domestic company, with all other attributes (collection of Austrian tax upstream, rate of taxation abroad, and so on) deemed irrelevant. Once again, the Court articulates no reason for this division of attributes that might take it beyond circular reasoning. The conclusion that corporations and shareholders are to be analysed separately obviously does not provide a reason for doing so.

The final two cases involved incoming dividends under imputation systems in which shareholder credits were available for dividends from domestic companies (which had paid corporate tax to the crediting country), but not for dividends from foreign companies (which had not paid corporate tax to the crediting country). In *Petri Manninen*,[59] the Court did not ignore the link between the shareholder and corporate taxes, as it had in *Verkooijen* and *Lenz*. In essence, Finland had converted its corporate tax into a withholding tax on dividends. It imposed a tax of 29 percent at both the corporate and shareholder level, but fully credited the corporate tax to shareholders. Distribution of a dividend that had not borne a corporate tax equal to the shareholder credit triggered a compensatory tax of the type described earlier. Mr Manninen owned shares in a Swedish company and claimed that Finland should allow him a shareholder credit for the corporate taxes paid to Sweden. The Court agreed and held the Finnish legislation violated the EC Treaty on the ground that the goal of eliminating Finnish economic double taxation could be achieved by Finland's granting credits not only for corporate taxes paid to Finland, but also for corporate taxes paid to *other* Member States![60]

Prior to this 2004 decision, one might have understood the ECJ as saying that a residence country's provisions to reduce corporate-shareholder economic double taxation had to be applied to foreign dividends, without regard to the tax situation in the source country. That is, an exemption (*Verkooijen*) or lower tax rate (*Lenz*) available for domestic dividends had to be extended

58. See ibid., paras. 30–33 and 38.
59. Case C-319/02, *Petri Manninen*, [2004] ECR I-7477.
60. Ibid., paras. 46–54

to dividends from other Member States, regardless of whether or how the paying corporation's income had been taxed by the foreign country. In contrast, the ECJ in *Manninen* required the residence country to *adjust* its imputation system to take account of the corporate tax paid in the source country.[61] According to the Court, if, for example, the source country had relieved economic double taxation with a dividend deduction, Finland would have been under no obligation to extend its imputation system to foreign dividends from that country; on the other hand, if the source country had a classic corporate-shareholder economic double taxation system, Finland would be required to provide a shareholder credit based on the tax rate in that country.[62] This is arguably an important departure from the ECJ's previous refusal to consider corporate and shareholder taxes together.[63] Alternatively, the Court's approach here may simply be a reflection of the fact that the Finnish legislation in *Manninen*, unlike the Austrian legislation in *Lenz*, linked the two taxes. Unfortunately, the Court provides no guidance on how its judgment should be understood.

In any event, under *Manninen*, a Member State *must* look to the corporate tax treatment abroad to determine whether its imputation credits need to be extended to foreign dividends, but the Member State *cannot* take into account whether it or the other Member State received the upstream taxes that the credit was designed to offset. As usual, there is no non-circular explanation of why the former attribute is relevant and the latter irrelevant.

Instead, the Court simply repeats a statement found in many ECJ decisions that a reduction in tax revenue is not a defence to discrimination.[64] This statement seems particularly unconvincing in the context of imputation, which essentially converts part or all of the corporate tax into a withholding levy on dividends paid to shareholders.[65] Had the Finnish corporate tax simply been labelled a withholding tax on shareholders, it is hard to imagine that the limitation of Finnish withholding credits to Finnish withholding taxes would have been found discriminatory by the Court.

61. Ibid., paras. 34–36.
62. Ibid., paras. 34 and 46, 54.
63. The ECJ did not go so far as the A.G., who had concluded that taxes on different taxpayers could be related if they were on the same income or economic process; *Manninen*, Opinion of A.G. Kokott, para 61.
64. *Manninen*, para 49.
65. For similar views, see Weber, "In search of a (new) equilibrium between tax sovereignty and freedom of movement within the EC", 34 *Intertax* (2006), 558, 599: "the Finnish corporate tax functions in the imputation system as a pre-payment for the Finnish income tax"; Englisch, "Fiscal Cohesion in the Taxation of Cross-Border Dividends", 44 *European Taxation* (2004), 323 (pt 1), 353 (pt2), at 359: "the limitation of a tax credit only to dividends paid out by resident companies is both legitimate and proportionate".

In 2007, the ECJ reaffirmed the *Manninen* results in *Meilicke*[66] by applying the same reasoning to the German imputation system, which was similar to the Finnish legislation. At para 40 of *Meilicke*, the Court indicated that *Lenz* and *Manninen* had simply confirmed the principles established by *Verkooijen*.

4.2.2. *Outbound dividends*

As described above, imputation may create a heavier tax burden on both incoming dividends (if residence-country shareholder credits are not extended to dividends from other countries) and outgoing dividends (if source-country credits are not extended to foreign shareholders). *Manninen* and *Meilicke* involved the first possibility. In 2004, the second was presented to the Court of the European Free Trade Area (EFTA), which applies the internal market concepts of the EU to certain neighbouring countries, including Norway, under the Agreement on the European Economic Area. In *Fokus Bank v. Norway*,[67] the EFTA Court considered Norway's imputation credit system, which allowed credits to resident, but not non-resident, individual shareholders. The credit was computed using the shareholder's tax rate, so dividends received by domestic shareholders were effectively exempt. In addition, dividends to foreign, but not domestic, individual shareholders were subject to a final withholding tax.

Relying on the ECJ decisions involving incoming dividends, the EFTA Court held that outgoing dividends also had to pass muster under the fundamental freedoms. This conclusion is hardly surprising, as the ECJ had never suggested that its analysis of cross-border dividends was limited to incoming dividends. And the European Commission's view has clearly been that neither outgoing nor incoming dividends may be taxed more heavily than domestic dividends, although it has never specified precisely what that means.[68]

Given the purpose of the Norwegian legislation (avoidance of economic double taxation), the EFTA Court held that Norway had to extend its share-

66. Case C-292/04, *W. Meilicke* v. *FA Bonn-Innenstadt*, judgment of 6 March 2007, nyr.

67. EFTA Case E-1/04, judgment of 23 Nov. 2004.

68. Communication from the Commission to the Council, the European Parliament and the European Economic and Social Committee: Dividend Taxation of Individuals in the Internal Market 20, COM(2003)810, 19 Dec. 2003. The Commission argued in *Fokus* that failure to grant imputation credits to foreign shareholders was discriminatory. EFTA Case E-2/04, Report for the Hearing, paras. 48–55. In *Manninen* (*supra* note 59) the Commission argued that the Finnish imputation system was flawed both because imputation credits were not available for incoming dividends and because they were not available for outgoing dividends, see Opinion of A.G. Kokott paras. 18, 68. The Commission recently confirmed its view that neither incoming nor outgoing dividends may be taxed more heavily than domestic dividends under the EC Treaty. See note 124, *infra*.

holder imputation credits to foreign, as well as domestic, shareholders in order to achieve equivalent treatment.[69] Norway argued that taxation of the dividends in the shareholder's residence country was relevant to determine whether domestic and outgoing dividends were treated equivalently. Citing the ECJ cases described above, the EFTA Court responded that discrimination in the source country could not be remedied by a tax advantage provided in a bilateral tax treaty or in legislation in the residence country,[70] arguably suggesting a different approach from *Manninen*, at least with respect to outgoing dividends.

The details of the Norwegian legislation (imputation in form, but functionally an exemption for domestic shareholders coupled with withholding on dividends to foreign shareholders) make it difficult to draw conclusions from *Fokus* for more standard imputation systems. On the one hand, *Manninen* and *Fokus* might be read together to require *both* source and residence countries to grant imputation credits to cross-border dividends, which could make the tax burden on international investment *less* than that on domestic investment.[71] On the other hand, as indicated above, *Manninen* arguably

69. *Fokus* para 30.

70. Ibid., paras. 37–38.

71. As an example of the possibility of lower taxation for cross-border dividends, consider the simple case of 2 partial imputation countries, each with a 50% corporate tax, a shareholder credit for half of the corporate taxes paid, and a shareholder tax rate of 50%. Assume a domestic corporation in country R that earns 100, pays 50 in corporate taxes and distributes the remaining 50 to domestic shareholders, who are eligible for a tax credit of 25. As shown in the table below, the corporate income of 100 will produce total taxes of 62.50, leaving R domestic shareholders 37.50 in cash. Now consider a company in country S that earns 100 and pays 50 in taxes to S. This company then distributes the remaining 50 to its shareholders in country R, along with a (refundable) tax credit of 25. The final result for these shareholders will depend on how R computes its shareholder credit on the incoming dividend. We show two illustrative possibilities below: (1) R provides the 100 of foreign corporate income the same 25 of credit it provides for 100 of domestic corporate income; and (ii) R provides the 75 of foreign dividends (cash plus S credit) an R shareholder credit at the same rate it provides for domestic dividends (25 of credit for every 50 of cash receipts). In either case, the cross-border dividend results in less total tax than the domestic dividend, when credits are mandated for both S and R. (In the interest of simplicity, the example assumes that S does not levy a withholding tax on the dividend. Such a tax would change the results, but not by much, given the low level of such taxes.)

	Domestic Shareholders	Foreign Shareholders (possibility 1)	Foreign Shareholders (possibility 2)
1. Corporate income	100.00	100.00	100.00
2. Cash distribution	50.00	50.00	50.00
3. Refundable tax credit from S	0	25.00	25.00
4. Tax credit from R	25.00	25.00	37.50 (75 x 25/50)
5. Taxable amount in R (2+3+4)	75.00	100.00	112.50
6. Gross tax in R (50% x .5)	37.50	50.00	56.25

makes the residence country's obligation conditional, depending on whether the source country has or has not itself relieved economic double taxation. Such conditionality would reduce the possibility of mandating lesser taxation of cross-border income than domestic income. In any event, we need to defer consideration of how the ECJ might react to the individual shareholder situation in *Fokus* until we discuss its decisions involving corporate parent companies in the next section.

Since *Fokus*, the ECJ has decided only one case involving outgoing corporate distributions to individual shareholders. *Bouanich*,[72] decided in 2006, concerned the repurchase (or *redemption*) of shares by a corporation from its shareholders. In many national tax systems, gains on sales of shares to third parties (amounts realized on sale minus cost *basis*) are taxed at lower capital gains rates than are dividends (which may be taxed in full with no reduction for basis). Redemptions are similar both to dividends, in that they distribute corporate cash to shareholders, and to sales of shares to third parties, in that the seller gives up some ownership in the corporation. The tax policy treatment of redemptions varies not only across countries, but within countries.[73] The United States, for example, taxes certain redemptions as dividends and others as sales.[74]

In *Bouanich*, the ECJ held that a Swedish provision taxing redemptions by Swedish companies of stock held by foreign shareholders as dividends (at a rate of 30 percent) violated the EC Treaty when redemptions by domestic shareholders were taxed as sales, producing capital gains (also taxed at a rate of 30 percent, but with basis recovery). The Court also invalidated Swedish legislation, based on the tax treaty between Sweden and France, which provided that French shareholders of Swedish shares would be taxed on redemptions at the rate of 15 percent after deduction of the par value of the stock,[75] unless Sweden could show that the treaty provision applicable to French shareholders was no less favourable than the Swedish legislation applicable to Swedish shareholders.[76]

Sweden apparently conceded that limiting basis recovery on redemptions to domestic shareholders violated the EC Treaty,[77] but we wonder why, in

7. Tax due in R (6–4)	12.50	25.00	18.75
8. After-tax cash (2+3–7)	37.50	50.00	56.25
9. Total taxes paid to S and R (1–8)	62.50	50.00	43.75

72. Case C-265/04, *Margaretta Bouanich* v. *Skatteverket*, [2006] ECR I-923.

73. See Ault and Arnold, *supra* note 22, at 299–301.

74. IRC S. 302.

75. This treatment is consistent with the OECD Model Tax Treaty. See Commentary, OECD MTC, Art. 10, paras. 28, 31.

76. *Bouanich*, *supra* note 72, para 56.

77. Ibid., paras. 24–25.

light of the differences in the tax treatment of residents and non-residents. Source countries do not generally tax capital gains or losses on sales of domestic stock by foreign portfolio investors.[78] Over time, the sum of the dividends received by a Swedish shareholder from a Swedish company plus gains and minus losses on sales of the stock will sum to the shareholder's total economic gain or loss on the investment.[79] That is simply not true for a foreign shareholder, who will typically be taxed on dividends, but not sales. Given that Sweden treats redemptions as sales,[80] and that foreign shareholders are not usually taxed on sales, extension of domestic redemption treatment to foreign shareholders could require exempting the latter, again resulting in more favourable treatment of cross-border investments than domestic investments.

4.2.3. *The ECJ's tax policymaking*

Earlier, we set forth seven basic issues that must be addressed in formulating a neutral or non-discriminatory system for taxing cross-border dividends. The ECJ's portfolio investment cases, which involve the intersection of economic and international double taxation, do raise many of those issues, but most of them have simply been ignored by the Court. In particular, the ECJ has refused (a) to consider (at least before *Manninen*) corporate and shareholder taxes together in evaluating the burden on corporate-source income; (b) to take into account which country taxed corporate income in evaluating taxation of the corporate income when distributed to shareholders; and (c) to offer a reasoned explanation why only some characteristics are relevant to its findings of discrimination while others are left out of account. The result is a series of judicial decisions that seem arbitrary and formalistic.

Tax policy is being made through the lens of non-discrimination by pair-wise comparisons that vary with the circumstances of the case. When inbound dividends are at issue, the Court compares a resident investing domestically with a resident investing abroad (the same comparison required for capital export neutrality) and asks if the law at issue disfavours the latter. If so, it is held (as in *Verkooijen*, *Lenz* and *Manninen*) to violate the treaties. When outbound dividends (or a redemption) are before the ECJ or the EFTA Court, the pair-wise comparison shifts, and the tax on a resident investor is compared with that on a non-resident investor (the same comparison required

78. Such sales may be taxed if they have some other connection to the source country, such as relating to the activity of a permanent establishment. See Ault and Arnold, *supra* note 22, at 397–417.

79. This assumes no step-up in basis at death, as under IRC s. 1014.

80. Ault and Arnold, *supra* note 22, at 301.

for capital import neutrality). If the latter is disfavoured, treaty violations are found (as in *Bouanich* and *Fokus*). These shareholder-level cases might therefore be read as requiring non-discrimination on the basis of both the origin and destination of investment, but any such conclusion has to be deferred until we reach the corporate-level decisions discussed in the next section.

Recall the context in which these decisions are being made. There is no harmonization of either income tax rates or bases in Europe. So a country, such as Ireland, can have a low corporate tax rate to promote investment there from anywhere in the world, including both domestic investment and investment from other Member States. But no Member State can have an integrated corporate tax system – whether in the form of imputation credits or dividend exclusions – that favours domestic investments over investments in any other Member State. It must allow its resident individual shareholders credits for corporate taxes paid to other Member States or an identical exclusion for dividends received from anywhere in the EU. If this requirement pushed Member States away from integrated corporate-shareholder taxes back toward a classic system with its economic double taxation of corporate profits – as it has – the Court will have contributed to widening the gap between the tax treatment of debt and equity that integration had narrowed. It is certainly not obvious that this is good tax policy for Europe. Given the role played by private equity firms today in structuring leveraged corporate buyouts, the debt-equity distinction may prove far more important to the ultimate ownership of European companies than a level playing field between equity investments in various Member States.

As for the particular tax policy dilemma we posed above (the need to choose between granting imputation credits to inbound or outbound dividends), the EFTA Court read the ECJ decisions to require both. In order to understand the ECJ's own reading of its decisions in that regard, we turn now to a series of recent cases involving corporate taxation under imputation. The legislation reviewed by the Court in these decisions is very complex, because it involves the potential overlap of multiple corporate taxation with both economic and international double taxation.

4.3. *Corporate taxation under imputation*

The ECJ has decided three cases involving corporate-level taxation under the former UK imputation system, which had three important attributes for our purposes.[81] The first was the Advance Corporate Tax (ACT), which was

81. For a more detailed description of the UK legislation, see Gammie, Pending Cases Filed by UK courts: The ACT and FII Group Litigation, in Lang, Schuch and Staringer (Eds.), *ECJ: Recent developments in Direct Taxation 2007* (2007), pp. 238, 244–256.

a compensatory tax, like that described above, with a wrinkle. The usual compensatory tax, such as the former French *précomte*, would be remitted by the corporation paying a dividend in order to bring corporate tax payments up to the level assumed by the shareholder credit. The wrinkle in the UK system was that ACT was *always* due when a company paid dividends, but it could later be credited against the company's regular (or *mainstream*) corporate tax.[82] Except for the timing, the ultimate result is the same as under a standard compensatory tax. After all the dust settles, one tax is paid at the company level (ACT plus mainstream tax minus ACT), for which shareholders receive a full or partial shareholder credit.

The second important attribute was the possibility of a *group election*. Under that possibility, no ACT was due on payments of a dividend by a UK subsidiary to a UK parent company, which would pay ACT on later dividends to its own shareholders. Such intercorporate dividends were not taxable when received by the UK parent company. No group election was available if the UK subsidiary's parent company was foreign, because foreign companies were not generally subject to UK tax. Dividends by a UK subsidiary to a foreign parent thus always required payment of ACT, which would offset the subsidiary's UK mainstream corporate tax when due. The foreign parent was not entitled to a shareholder credit unless a bilateral tax treaty provided for such a credit, in which case the dividend and credit were subject to UK withholding tax.

The third attribute was the treatment of a dividend from a UK subsidiary to a UK parent company in the absence of a group election. In this case, the subsidiary did pay ACT. The parent company was not taxed on the dividend (called *franked investment income*) and could use the subsidiary's ACT to offset its own ACT obligations when it later paid a dividend to its shareholders.

To summarize: a dividend paid by a UK subsidiary to a UK parent company was subject to two possible treatments. If there was a group election, ACT was not paid by the subsidiary, but would be remitted by the parent company later when it paid a dividend. If there was no group election, the subsidiary paid ACT, but the parent was not liable for ACT when it later paid a dividend to its shareholders. In neither case was the dividend taxable to the UK parent company. A dividend received by a foreign parent company from a UK subsidiary, which always had to pay ACT, was also subject to two possible treatments. In the absence of a treaty provision, the UK neither taxed the dividend nor granted a shareholder credit. On the other hand, in certain bilateral

82. Companies remained liable for a minimum corporate tax, equal to the difference between the corporate rate and the ACT rate. See id. at p. 245.

treaties, the UK agreed to grant a full or partial credit, with the dividend and credit subject to UK withholding tax.

In a 2001 case, *Metallgesellschaft Ltd and Others*,[83] UK subsidiaries of foreign parent companies complained that they were disadvantaged in terms of present value, relative to UK subsidiaries of UK parents who had made a group election, because they always had to pay ACT and wait for the credit against mainstream tax. The ECJ held that this differential – which ranged from 8.5 to 17.5 months – violated the EC Treaty. As in *Verkooijen*, the Court refused to consider the taxes on corporations and shareholders as related. Indeed, the Court insisted that "ACT is in 'no sense' a withholding tax on dividends but rather an advance payment of corporation tax"[84] – ignoring altogether the fact that the UK enacted the ACT as a mechanism to facilitate its shareholder credit system.

If, on the other hand, the corporate and shareholder taxes were considered together, it could make perfect sense to collect ACT when corporate income is distributed to a foreign parent (since that income is leaving the UK tax system), and not to collect ACT when such income is paid to a UK parent (because ACT can be collected on later distributions by the parent). Rather than analysing the totality of taxes on the flow of corporate-source income, however, the ECJ concluded that a foreign parent and a domestic parent were in the same position, because they were both exempt from taxation in the UK on dividends from UK subsidiaries. The Court conceded that they were exempt for different reasons: foreign parent companies were not subject to corporate taxation in the UK, whereas UK parent companies were not taxed to avoid multiple corporate taxation. That difference was dismissed as irrelevant, once again with no explanation provided for that determination.[85] Given its postulated identity of position for domestic and foreign parent companies, the Court concluded that any difference in the taxation of a UK subsidiary must be discriminatory.

Remarkably, the ECJ also reasoned that subsequent repeal of the ACT provisions meant that they must not have been an essential part of the UK tax system.[86] As a reason to strike down the ACT provisions, this is not only a

83. Joined Cases C-397 & C-410/98, *Metallgesellschaft Ltd and Others*, *Hoechst AG and Hoechst (UK) Ltd* v. *Commissioners of Inland Revenue and HM Attorney General*, [2001] ECR I-1727. See also, *Boake Allen Limited and Others* v. *Her Majesty's Revenue and Customs*, [2007] UKHL (23 May 2007), holding that ACT paid by UK subsidiaries to parent companies from outside the EU did not give rise to a claim for compensation under either the EC Treaty (in light of a grandfather clause) or the applicable tax treaty.

84. *Metallgesellschaft*, paras. 6, 52.

85. Ibid., para 70.

86. Ibid., para 74.

non-sequitur, it is circular reasoning at its worst, for many commentators report that the UK repealed its ACT imputation system, at least in part, because it anticipated that the ECJ would strike it down.[87]

In 2006, the Court decided two additional cases regarding dividends received by corporate parents under the former UK imputation system, one involving outbound dividends (as in *Metallgesellschaft*) and one involving inbound dividends. In *ACT Test Claimants*,[88] foreign parent companies of UK subsidiaries argued that the ACT system was discriminatory because dividends to foreign companies did not carry shareholder credits unless they were granted under a bilateral tax treaty.[89] Unlike earlier cases, including *Metallgesellschaft*, in which the Court refused to consider corporate and individual income taxes together, the ECJ here described the dividends as potentially subject to both multiple corporate taxation and economic double taxation.[90] The Court also stated that it is for the Member States to determine whether, and to what extent, "a series of charges to tax" (its terminology for multiple corporate taxation) and economic double taxation are to be avoided.[91] Although *Manninen* held that shareholder credits had to be granted on incoming dividends (to individuals), the Court decided here that such credits did not have to be granted on outgoing dividends (to corporations) because that "would mean in point of fact that that State would be obliged to abandon its right to tax a profit generated through an economic activity undertaken *on its territory*"(para 59, emphasis added). Nor was the UK prohibited from granting imputation credits to only some Member States by way of bilateral treaties.[92]

Applying the language quoted just above to inbound dividends leads to the conclusion that *Manninen* requires a Member State "to abandon its right to tax a profit generated through economic activity undertaken" *by its residents*, at least for individual shareholders. Reading these two decisions together arguably leads to the conclusion the ECJ has chosen to prohibit discrimination based on the destination, but not the origin, of investment. Unfortunately, other cases cast doubt on that conclusion, and, in any event, the Court fails utterly to offer a reasoned account of its choice. Beyond the language quoted at

87. See e.g. Vann, op. cit. *supra* note 7, at 66.

88. Case C-374/04, *Test Claimants in Class IV of the ACT Group Litigation* v. *Commissioners of Inland Revenue*, [2006] ECR I-11673

89. This was an alternative argument of the taxpayers in *Metallgesellschaft*, but the Court did not reach the issue; cf. *Metallgesellschaft*, *supra* note 83, para 97.

90. *ACT Test Claimants*, *supra* note 88, para 49.

91. Ibid., para 54.

92. Ibid., paras. 75–94. Nor was the UK precluded from limiting the benefit of these credits to companies resident in the other Member State. Ibid., para 92.

the end of the previous paragraph, the only two explanations the Court offers are that residence countries are best placed to determine a taxpayer's overall ability to pay and that the Parent-Subsidiary Directive requires the residence country to relieve double taxation.[93] The first simply does not engage the underlying tax policy issue, which is the division of the tax base between source and residence countries. Nor does it explain why administrative differences between source and residence countries should determine fundamental rights under the EC Treaty, particularly since the Court has regularly rejected arguments of Member States based on administrative considerations.[94] The second is disingenuous at best, because it ignores the mandate of the Parent-Subsidiary Directive that source countries *exempt* covered dividends from withholding taxes.[95]

The Court's application of its non-discrimination methodology in *ACT Test Claimants* seems particularly manipulative. The claimants argued that UK and foreign parent companies were in comparable positions because both were exempt from UK taxation on dividends from UK subsidiaries.[96] That was precisely the attribute the ECJ found relevant in *Metallgesellschaft* (category 1 in our description of the Court's methodology). Here the ECJ classified this attribute as irrelevant and demoted it to category 3. The Court also concluded that UK and foreign parent companies were dissimilar because the UK could extend shareholder credits on dividends by the former, but not the latter.[97] This conclusion is puzzling in light of the Court's rejection in *Metallgesellschaft* of the argument that UK and foreign parent companies are dissimilar because the UK can collect ACT on dividends by the former, but not the latter.[98] Its analysis here also seems inconsistent with its decision in *Bouanich*, where resident and non-resident individuals were treated by the Court as in comparable positions. Finally, the ECJ observed that in the case under consideration (dividends from a UK subsidiary to a foreign parent company), the UK would be subject to the *residence-country* obligation in *Manninen* to extend imputation credits to foreign dividends if the foreign parent company itself had UK individual shareholders.[99] While true, that observation does not help resolve the question before the Court, which is whether there is a *source-country* obligation to extend imputation credits to outgoing dividends.

93. Ibid., para 60.
94. See e.g. *Manninen*, *supra* note 59, para 54.
95. Council Directive 90/435/EEC of July 23, 1990, Art. 6.
96. *ACT Test Claimants*, *supra* note 88, para 48.
97. Ibid., paras. 61–63.
98. *Metallgesellschaft*, *supra* note 83, paras. 45–51.
99. *ACT Test Claimants*, *supra* note 88, paras. 64–66.

In the absence of any articulated legal basis for permitting differential treatment by source, but not residence, countries, one suspects that the Court may have subscribed to the view of the Advocate General in this case that international tax law gives priority to "source-country entitlement" and so should the ECJ.[100]

International tax law does not, however, constitute a convincing rationale for requiring non-discrimination based on the destination, but not the origin, of corporate investment. To begin with, "source-country entitlement" does not begin to capture the complexity of the division of the income tax base between source and residence countries described above. More importantly, it makes no sense to invoke international tax law to prohibit something that international tax law has always permitted. As we explained earlier, residence and source countries have never been required under international tax principles to extend shareholder credits to either inbound or outbound dividends. International tax principles cannot therefore provide a basis for the ECJ's decisions requiring extension of such credits to inbound, but not outbound, dividends. Nevertheless, that choice seemed to be confirmed by a residence-country case decided the same day as *ACT Test Claimants*. In *FII Test Claimants*,[101] the Court considered incoming dividends from foreign subsidiaries to UK parents. As indicated above, a dividend of franked investment income (FII) from a UK subsidiary to a UK parent would be non-taxable to the parent, and the parent would be able to use the subsidiary's ACT to offset the ACT otherwise due when it paid dividends to its individual shareholders. On the other hand, when a UK parent received a dividend from a foreign subsidiary, the UK taxed the parent on the dividend, subject to a tax credit for any foreign withholding tax and (if the UK parent owned at least 10 percent of the subsidiary) allowed an indirect foreign tax credit for corporate taxes paid to the foreign country by the subsidiary. When the UK parent company distributed a dividend out of foreign income to its shareholders, ACT would be due. In order to mitigate the burden of such ACT, the UK parent could declare the dividend it paid out of foreign income as a *foreign income dividend* (*FID*), in which case the parent company could claim a refund for that ACT when its mainstream corporate tax was due. Individual shareholders would not receive a tax credit, but the FID would be treated as if it had borne taxation "at the lower [UK] rate."[102]

100. Ibid., Opinion of A.G. Geelhoed, para 51.

101. Case C-446/04, *Test Claimants in the FII Group Litigation* v. *Commissioners of Inland Revenue*, [2006] ECR I-11753.

102. Ibid., para 25. The FID system was in effect from 1994 to 1999. Ibid., at paras. 23, 26.

In a very long and complicated ruling, the ECJ affirmed the obligation of residence countries to eliminate international double taxation on incoming dividends. For our purposes, there are three key holdings:[103]

(i) In principle, a Member State can have an exemption system for dividends from domestic subsidiaries and tax credit system for dividends from foreign subsidiaries, provided that foreign-source dividends "are not subject in that Member State to a higher rate of tax than the rate which applies to nationally-sourced dividends."[104]

This holding indicates that exactly the same treatment need not be applied to domestic and foreign income, as long as the effect is the same. What that means is less than pellucid, for the Court did not specify what it meant by equivalent tax rates. The Court did, however, apply the logic of this holding to corporate portfolio investments, by requiring the extension of the indirect foreign tax credit to shareholdings of less than ten percent of a foreign corporation.[105]

The second key holding concerned the complex interaction of multiple corporate taxation, economic double taxation, and international double taxation:

(ii) The EC Treaty was violated when a UK parent company receiving dividends from a UK subsidiary could use ACT paid by the latter to reduce its own ACT liability on distributions to its shareholders, but a UK parent company receiving dividends from a foreign subsidiary could not reduce its own ACT liability by the amount of *foreign* taxes paid by the subsidiary.[106]

Evaluating this holding requires unpacking the relationship among ACT, the foreign tax credit, and the shareholder imputation credit. Consider first a purely domestic case, with a 30 percent corporate tax rate, in which a domestic subsidiary earns 100, pays ACT (and mainstream corporate tax) of 30, and distributes 70 to its parent company as franked investment income. The dividends are non-taxable to the parent company, which pays no further ACT on distributions to its individual shareholders. The individual shareholders are taxed on 100 of income, but benefit from an imputation credit, which we assume to be 30 in this example. If the shareholder's tax rate is 30 percent,

103. The Court also held that if ACT can be surrendered by a UK parent company to its resident subsidiaries, ACT has to be surrenderable to non-resident subsidiaries subject to the UK corporate tax as permanent establishments. *FII Test Claimants*, paras. 132–134.

104. *FII Test Claimants*, paras. 49–57.

105. Ibid., para 74. In response to this holding, the UK is considering various ways of making the treatment of domestic and foreign portfolio dividends received by UK corporations conform to EC law. See HM Treasury, "Taxation of companies' foreign profits: Discussion document", para 3.15 (June 2007).

106. Ibid., paras. 90–94.

he ends up with 70 after all taxes. The UK has collected one tax of 30 on the domestic corporate income stream of 100. The parent's ability to credit its subsidiary's ACT avoids multiple *corporate* taxation, while the individual shareholder's imputation credit avoids *economic* double taxation.

Now consider a foreign subsidiary of a UK parent, which earns 100 and pays 30 in the foreign country. On receipt of 70 in cash, the UK parent company has taxable income of 100, but owes no taxes after application of the indirect foreign tax credit, which avoids *international* double taxation and multiple *corporate* taxation. What should then happen on distribution by the parent company of this foreign-source income to its individual shareholders? Under the UK legislation (and most other imputation systems), 30 of ACT would be payable. Otherwise, the shareholder would receive a UK tax credit for 30 of taxes *not* collected by the UK due to the foreign tax credit at the company level. Given the foreign tax credit, there would be no mainstream corporate tax for the 30 of ACT to offset, so that amount was often called *surplus ACT*. In effect, collecting ACT at this point restores *international* and *economic* double taxation when the income is distributed to individual shareholders. By requiring the parent company to offset its ACT with the foreign taxes paid by its subsidiary, the ECJ is effectively requiring the UK parent to pass the corporate foreign tax credit through to its shareholders.

It is not at all clear that the Court saw these relationships when it stated, "the ACT payable by a United Kingdom-resident company is *nothing more* than a payment of corporation tax in advance" (para 88, emphasis added). As in *Metallgesellschaft*, the Court seems to be analysing the relevance of the ACT only at the corporate level.[107] At one point, the Court uses its formula for multiple *corporate* taxation to describe the ACT as "a national measure which is designed to avoid a series of charges to tax on distributed profits" (para 91). By ignoring the ultimate effect on shareholder-level taxes of both ACT and the corporate foreign-tax credit, the ECJ is able to find a cash flow advantage for domestic dividends in that ACT is due on the distribution of foreign dividends, subject to later crediting against mainstream tax (paras. 89-94).

The third key holding is an example of the proverb that "no good deed goes unpunished":

(iii) The FID regime violated the fundamental freedoms because (a) UK parent corporations receiving foreign dividends would have to wait for a refund of ACT until they owed mainstream tax, and (b) shareholders receiving

107. Cf. Ibid., Opinion of A.G. Geelhoed, para 5 (under imputation systems, the corporation tax serves as a "prepayment for all or part of the shareholder income tax").

FIDs would be effectively taxed at a standard lower rate, rather than taxed subject to a refundable imputation tax credit.

The FID regime was an attempt by the UK to reduce (or eliminate) the additional burden on incoming dividends that the Court eventually invalidated in holding (ii). Rather than directly passing through the corporate-level foreign tax credit to individual shareholders, the UK instead taxed those shareholders at a lower rate on FID and refunded ACT paid by the distributing corporation.[108] The ECJ found these provisions incompatible with the EC Treaty, because they failed to treat foreign income identically with domestic income.

To recapitulate: reading *ACT Test Claimants* and *FII Test Claimants* together suggests that the Court has decided that residence, but not source, countries must relieve the international double taxation of dividends, at least when paid to corporate shareholders under an imputation system. If the approach of these two decisions were applicable to dividends paid to individual shareholders under imputation, the ECJ's case law would reject the analysis of *Fokus*, even though neither of these recent ACT decisions mentions that EFTA case.[109] In the conventional language of international tax policy, the ECJ would have chosen to enshrine capital export neutrality, but not capital import neutrality, as a fundamental freedom.[110] This conclusion is uncertain, however, because the *Bouanich* decision (involving redemptions), decided just 11 months before *ACT Test Claimants*, does require the source country to make the same concessions to foreign and domestic shareholders.

In any event, once the ECJ's assertion of source entitlement is put aside, no substantial reason can be found in Court's decisions for its apparent choice to impose a heavier burden on residence countries – if indeed that is its choice. Understanding the potential scope of that burden requires consideration of two final decisions, both concerning withholding taxes.

108. For other proposals to approximate the effect of passing though the foreign tax credit by providing an exemption for shareholders, see the ALI Report, *supra* note 8; Taylor, "Approximating capital-export neutrality in imputation systems: Proposal for a limited exemption approach", 57 IBFD Bulletin (2003), 135.

109. The Advocate General in *ACT Test Claimants* indicated that he disagreed with the approach of the EFTA Court because it did not take into account the relevant tax treaty; *ACT Test Claimants*, *supra* note 88, Opinion of A.G. Geelhoed. As noted above, *Fokus* involved both imposition of a withholding tax and failure to extend imputation credits on outgoing dividends to individual shareholders. The UK system in *ACT Test Claimants* involved the latter, but not the former, but the EFTA Court's analysis in *Fokus* does not turn on the distinction.

110. Cf. Stahl, "Dividend Taxation in a Free Capital Market", 6 *EC Tax Review* (1997), 227, arguing for EU legislation extending shareholder credits for individual portfolio investors to foreign income, but not foreign shareholders, to implement capital export neutrality.

4.4. *Withholding taxes*

In late 2006, the ECJ decided two cases involving withholding taxes on dividends paid to foreign shareholders. (Recall that, in the international context, withholding taxes are, in fact, final taxes imposed by source countries on dividends paid to foreign shareholders. Reducing the level of these taxes is an important function of bilateral tax treaties.) The first case concerned inbound dividends, while the second involved outbound dividends.

Kerckhaert and Morres concerned individual shareholders in Belgium who received dividends from a French company.[111] Pursuant to the French-Belgian tax treaty, the Belgian shareholders received the French shareholder credit (*avoir fiscal*, mentioned above) and were subject to a French withholding tax on the sum of the cash dividend and the credit. Under Belgian law, all dividend receipts, whether domestic or foreign, were subject to taxation at the rate of 25 percent. The shareholders argued that their French dividends were subject to higher taxation than domestic dividends, because Belgium did not provide a credit for the French withholding tax. The ECJ held that Belgium had not violated the EC treaty because it treated domestic and foreign dividends identically. The additional burden on cross-border dividends resulted "from the exercise in parallel by two Member States of their fiscal sovereignty" (para 20).

We have several comments on *Kerckhaert.* First, to our way of thinking, virtually every decision discussed in this article involves the exercise in parallel by two Member States of their fiscal sovereignty. That is precisely what produces the interactions among multiple corporate taxation, economic double taxation and international double taxation at issue in these cases.

Second, if *Kerckhaert* is to be taken as a definitive statement of the ECJ's views, Member States apparently may, but need not, reduce international double taxation by a bilateral tax treaty or domestic legislation.[112] Indeed, the Advocate General's Opinion, reaching the same result, explicitly states that residence countries are under no obligation to eliminate international double taxation, but (citing *Verkooijen*, *Lenz* and *Manninen*) they must extend domestic provisions reducing economic double taxation to foreign

111. Case C-513/04, *Mark Kerckhaert and Bernadette Morres* v. *Belgium*, [2006] ECR I-967.

112. Ibid., paras. 21–23. Whether Member States are obligated to relieve international double taxation has been a matter of some dispute, with varying views about whether it would be the obligation of source or residence countries to provide the relief. See e.g. Lang, "Double Taxation and EC Law", in Avi-Yonah, Hines and Lang (Eds.), *Comparative Fiscal Federalism: Comparing the European Court of Justice and the US Supreme Court's Tax Jurisprudence* (KLI, 2007).

dividends.[113] This means that if the greater tax burden on investments by a resident of one Member State in companies of another Member State is due to the resident country's decision to integrate its corporate and shareholder taxes, it violates the EC Treaty, but if the greater burden is due to the imposition by the source country of a (final) withholding tax on dividends paid to foreigners, no Treaty violation occurs. We cannot see how this distinction advances either the economic integration of Europe or the tax policies of its Member States. If the ECJ's concern is with the elimination of tax barriers to the free movement of capital within Europe, as the Treaty's text suggests, it is difficult to understand why it should matter whether such barriers arise from economic or international double taxation.

Third, *Kerckhaert* again poses the question whether the ECJ fully understands the structural similarity of dividend withholding and corporate imputation. Under *Manninen*, the Court required a residence imputation country to provide individual shareholder credits for inbound dividends. Suppose, however, that a residence country repealed its 30 percent corporate tax along with its full imputation credit and substituted refundable withholding of 30 percent on domestic dividends. The effect on domestic dividends received by domestic shareholders would be unchanged. In both cases, payment of a cash dividend of 70 would result in taxable income of 100 and a credit of 30 at the shareholder level.[114] Since these provisions would produce essentially similar results, consistency would presumably require the ECJ to hold that enactment of such domestic withholding required the residence country to grant shareholder credits for a foreign taxes. Alternatively, adoption of domestic withholding might require domestic credits for foreign withholding. Neither decision seems likely to us, as there is no indication that the Court thinks of imputation and withholding as functional equivalents under any circumstances.

We do not mean, by raising these questions, to criticize the ECJ for failing to comprehend a rather subtle tax policy relationship. Our Supreme Court would be unlikely to do any better. Such an analytical shortcoming seems inevitable when complex tax policy decisions come to be decided by a court that uses a single criterion such as non-discrimination as the exclusive touchstone for the resolution of those issues.

113. *Kerckhaert and Morres*, Opinion of A.G. Geelhoed, para 34.

114. Any difference in timing due to retention of earnings at the company level could be reduced by requiring a minimum withholding payment each year equal to 30% of corporate income.

The second international withholding case, *Denkavit* v. *Ministre de l'Économie*, *des Finances et de l'Industrie*,[115] involved outbound dividends paid by a French subsidiary to a Dutch parent company prior to the effective date of the Parent-Subsidiary Directive. Under French law, dividends to foreign parent companies were subject to a final withholding tax at the rate of 25 percent (reduced to 5 percent by treaty), while dividends paid to domestic parents were almost fully exempt from tax. The ECJ held that this distinction violated the EC Treaty. The France-Netherlands tax treaty provided that the Netherlands could tax such dividends, subject to a tax credit for French withholding. (In fact, Dutch legislation exempted such dividends.) France argued that the bilateral tax treaty should be respected as a means of allocating taxes on dividends between the two Member States. The Court rejected this argument, on the ground that neither the tax treaty nor the Dutch legislation remedied the higher tax burden in France of dividends paid to foreign parent companies.[116]

As noted above, the ECJ in *Manninen* held that the residence country's obligation to extend imputation credits to incoming dividends was conditional on the source country not having already eliminated international and economic double taxation. In contrast, the EFTA Court in *Fokus* made the source country's obligation to extend such credits mandatory, without regard to the situation in the residence country. The ECJ's language in *Denkavit* is unclear on the question of conditionality. Some commentators have concluded that the Court adopted an "overall" approach, as in *Manninen*, while other commentators read the decision as applying a "per country" approach, as in *Fokus*.[117] Assume for a moment that *Denkavit* should be read as creating an obligation to extend a withholding exemption on domestic dividends to outgoing dividends only where no credit is available in the residence country. Now consider *Manninen* and *Denkavit* together. Does the combined logic of those decisions create the possibility that the source country's obligations would depend on the residence country's resolution of its obligations, which would in turn depend on the source country's resolution of its obligations, and so on?

115. Case C-170/05, *Denkavit Internationaal BV et Denkavit France SARL* v. *Ministre de l'Économie*, *des Finances et de l'Industrie*, [2006] ECR I-11949.

116. The Court seemed to suggest that a different result might obtain where the residence country did grant a unlimited tax credit, *Denkavit*, para 46.

117. Cf. Vanistendael, "Denkavit Internationaal: The Balance Between Fiscal Sovereignty and the Fundamental Freedoms?" 16 *European Taxation* (2007), 210, arguing that the ECJ has adopted a "per country" approach; with Meussen, "Denkavit Internationaal: The Practical Issues, 16 European Taxation", (2007), 244, arguing that the ECJ has adopted an "overall" approach.

Denkavit, which held that a withholding exemption must be extended to dividends paid to foreign parent companies, was handed down two days after *ACT Test Claimants*, which held that shareholder credits need not be extended to dividends paid to foreign parent companies. The *ACT Test Claimants* decision was justified on the ground of preserving source-country taxation, but that rationale would seem equally applicable to *Denkavit*, which required the source country to forgo tax.

The ECJ seems to distinguish these two cases on the basis that *Denkavit* involved a shareholder-level tax while the tax at issue in *ACT Test Claimants* was a corporate-level tax.[118] But this, once again, seems to misunderstand the relationship between withholding and imputation, here with regard to outgoing dividends. We offer two final examples of that relationship. (In the interest of simplicity, we assume that there is no bilateral tax treaty to be taken into account.)[119] Consider first a source country that is deciding among three tax policies. The first policy would impose a corporate tax of 30 percent on operating subsidiaries, with a full imputation credit for domestic, but not foreign, parent companies. The second would impose no corporate tax on operating subsidiaries, but a final withholding tax of 30 percent on dividends to foreign, but not domestic, parent companies. The third would impose no corporate tax on operating subsidiaries, but a withholding tax of 30 percent on dividends paid to both foreign and domestic parent companies. As shown in the table below, the foreign parent would receive 70 net of source country taxes in each case, while the domestic parent would receive taxable income of 100, composed of either 100 in cash or 70 in cash plus a tax credit of 30.[120]

118. *Denkavit*, paras. 34–41.

119. The ECJ discussed tax treaties in a number of the cases discussed in this article. See *Avoir Fiscal*, *supra* note 41 (treaty did not apply to income in the case); *St. Gobain*, *supra* note 43 (mandating extension of benefits under treaties with non-Member States to a French permanent establishment); *Metallgesellschaft*, *supra* note 83 (based on its decision on exemption, Court did not need to decide treaty issue); *Bouanich*, *supra* note 72 (legislation based on treaty violates EC Treaty unless national court finds that foreign investor is treated no worse than domestic investor); *ACT Test Claimants*, *supra* note 88 (overall balance of treaties respected, including limitations on benefits and absence of MFN clause); *Kerckhaert*, *supra* note 111 (treaty not in issue, because superseded by Member State legislation); *Denkavit*, *supra* note 115 (treaty did not remedy additional burden on outgoing dividends, apparently because foreign tax credit in country was subject to the standard limitation); see generally Panayi, *Double taxation*, *Tax Treaties*, *Treaty shopping and the European Community* (KLI, 2007).

120. Any difference in timing due to retention of earnings at the parent company level could be reduced by requiring a minimum withholding payment each year equal to 30% of corporate income.

	Foreign Parent	Domestic Parent
Policy 1	70 in cash	70 in cash, 30 in tax credit (imputation)
Policy 2	70 in cash	100 in cash, 0 in tax credit
Policy 3	70 in cash	70 in cash, 30 in tax credit (withholding)

As far as we can tell, the first policy would be permitted by *ACT Test Claimants*, the second would be prohibited by *Denkavit*, and the third permitted by *Denkavit.* Given the essential similarity of results under the three policies, this is a set of outcomes that makes no sense to us either as a matter of tax policy or as an interpretation of the EC Treaty.

Our last example involves individual, rather than corporate, shareholders. A source country would like dividends distributed by domestic companies to domestic individual shareholders to bear an overall tax burden of 20 percent, while those distributed to foreign individual shareholders would bear an overall source-country tax burden of 30 percent. One way to accomplish that goal would be to levy a corporate tax of 20 percent, exempt dividends received by domestic shareholders, and impose non-refundable withholding of 12.5 percent on dividends paid to foreign shareholders. Domestic shareholders would receive 80 in cash, while foreign shareholders would receive only 70.[121] Given the ECJ's holdings in *Bouanich* (lower taxation of redemptions to domestic individual shareholders must be extended to foreign individual shareholders) and *Denkavit* (withholding exemption for domestic corporate shareholders must be extended to foreign corporate shareholders), we think it likely that the Court would hold that these provisions violated the EC Treaty.

Now consider an alternative means of accomplishing the same goal: corporate income is taxed at 30 percent, domestic individual shareholders are taxed on dividends at 20 percent subject to a refundable imputation credit of 30, and foreign shareholders neither benefit from the imputation credit nor suffer the detriment of a withholding tax. As in the previous paragraph, foreign shareholders would receive 70, and domestic shareholders would receive 80, net of all taxes.[122] The ECJ's decision in *ACT Test Claimants* (shareholder credits need not be extended to foreign corporate shareholders), as well as its apparent rationale (source-country primacy) suggests that the Court would not require the extension of imputation credits on outgoing dividends to individual shareholders. The EFTA's holding in *Fokus* arguably requires such an extension, but the ECJ has so far manifested no inclination to endorse that

121. A dividend to a foreign shareholder would bear 10 in withholding taxes (i.e. 0.125 x 80), yielding an after-tax return of 70.

122. A domestic shareholder would be taxed on 100, yielding a pre-credit tax of 20, a net tax credit of 10, and an after-tax return of 80. See note 5, *supra*.

approach, which would not be consistent with source-country primacy. Once again, different results in the two hypotheticals makes no sense to us as a matter of tax policy or Treaty interpretation.

Finally, the ECJ's two recent withholding decisions, *Kerckhaert* and *Denkavit*, provide additional reasons for caution in concluding that *ACT Test Claimants* and *FII Test Claimants* should be read to prefer capital export neutrality over capital import neutrality.[123] *Kerckhaert* declined to require crediting of foreign taxes by a residence country, while *Denkavit* required a source country to extend withholding exemptions to foreign shareholders.

5. Conclusions

As should be evident by now, there are considerable uncertainties regarding the scope of the decided ECJ cases, and additional dividend cases are in the Court's pipeline.[124] In particular, the Court has not provided clear guidance regarding the implications for individual shareholders of its decisions involving shareholders that are corporations, and vice versa. And the European Commission continues to challenge differences in taxation of both inbound and outbound dividends.[125] Nonetheless, the ECJ's dividend decisions up to the autumn of 2007 may be summarized as follows, starting in the upper-right quadrant of the lower half of the table in the Appendix and proceeding clockwise:

123. See the text *supra* at note 109.

124. Pending ECJ cases involving cross-border dividends include: Case C-379/05, *Amurta* v. *Inspecteur van de Belastingdienst*, (Dutch refundability of domestic, but not foreign withholding); Case C-194/06, *Staatssecretaris van Financien* v. *Orange European Smallcap Fund*, (Dutch restriction on tax concessions for outgoing dividends); and Case C-284/06, *Hamburg-Am Tierpark* v. *Burda*, (German compensatory withholding on outgoing dividends from a subsidiary). The Commission has also recently announced infringement proceedings against many Member States with respect to both inbound and outbound dividends: Commission requests Belgium to end discriminatory taxation of inbound dividends (IP/06/l045, 20 July 2006); Commission requests Belgium, Spain, Italy, Luxembourg, The Netherlands and Portugal to end discriminatory taxation of outbound dividends (IP/06/1060, 25 July 2006); Commission requests Greece to end discriminatory taxation of dividends from foreign companies (IP/06/1410, 17 Oct. 2006); Commission decides to refer Belgium, Spain, Italy, The Netherlands, and Poland to the Court over discriminatory taxation of outbound dividends and asks Latvia to end such discriminatory taxation (IP/07/66, 22 January 2007); Commission decides to refer Belgium to the Court over discriminatory taxation of inbound dividends (IP/07/67, 22 Jan. 2007); Commission asks nine Member States for information on discriminatory taxation of dividends and interest paid to foreign pension plans (IP/07/616, 7 May 2007); Taxation of outbound dividends: Commission takes steps against Austria, Germany, Italy and Finland (IP/07/1152, 23 July 2007).

125. See press releases in the previous footnote.

1. Individual shareholder provisions designed to reduce domestic economic double taxation (whether by exemption, rate reduction, or imputation credits) must be extended by residence countries to dividends from foreign companies (at least where the source country has not itself eliminated economic double taxation). Shareholder credits, however, need not be given for foreign withholding on dividends (as least where there is no similar domestic withholding).

2. Provisions that are designed to reduce multiple corporate taxation and international double taxation (such as dividend exemptions and the foreign tax credit) must be extended by residence countries to branches of foreign parent companies. Likewise, provisions designed to reduce multiple corporate taxation and economic double taxation (such as exemptions from compensatory taxes and shareholder imputation credits) must be extended by residence countries to dividends from foreign subsidiaries.

3. Exemptions from withholding and compensatory taxes designed to reduce multiple corporate taxation must be extended by source countries to foreign parent companies, but shareholder imputation credits designed to reduce economic double taxation need only be extended to domestic branches of foreign parents.

4. Domestic capital gains taxation of redemptions, and perhaps domestic shareholder credits designed to reduce economic double taxation, must be extended by source countries to foreign individual shareholders.

Each of the statements in the summary above embodies a complex tax policy judgment. Many, if not most, are contrary to the decisions that have emerged from Member State legislative processes and bilateral tax treaty negotiations. They substantially inhibit the flexibility of EU Member States to address the vexing issues of multiple corporate taxation, economic double taxation, and international double taxation. It is impossible, in our view, to identify consistent tax policy norms that would explain these results. In practice, these ECJ decisions have driven the Member States away from imputation credits and toward dividend exclusions as a way to alleviate economic double taxation. Such a choice would normally turn on such tax policy considerations as compliance and administrative costs, and whether the Member State views corporate or shareholder tax rates as more appropriate for dividend income,[126] considerations that are completely absent from the ECJ's determinations. Moreover, by insisting that foreign and domestic dividends be treated the same, the ECJ has made it more expensive to eliminate or reduce econom-

126. See generally Graetz and Warren, "Integration of Corporate and Individual Income Taxes: An Introduction", 84 *Tax Notes* (27 Sept. 1999), 1767.

ic double taxation, thereby reducing the likelihood (or extent) that Member States will do so, and enlarging the differences in taxation of debt and equity. It is certainly not obvious that the resulting tax policy for Europe is superior to the imputation systems that the ECJ has effectively eliminated.

Putting tax policy aside, is there any principled basis on which the Court's dividend decisions can be explained? We consider five possibilities.

First, as we describe above, the ostensible non-discrimination case law of the ECJ fails to provide such a principled basis, because the Court consistently fails to explain why some characteristics, but not others, are relevant to its non-discrimination inquiry. As we have noted, that inquiry is often resolved by appealing to a stock of rhetorical oppositions (such as comparable versus non-comparable attributes and exercise versus allocation of tax jurisdiction).[127] These sorts of abstract, rhetorical oppositions in judicial opinions have explanatory power only if they can be connected with concrete decisions that cannot otherwise be elucidated. We cannot make such a connection in the cases discussed above.[128] Consider once again the differential treatment of withholding and imputation credits; none of the Court's rhetorical oppositions elucidates that distinction, which seems to turn on conceptualizing the withholding tax as a separate shareholder-level levy.

Second, while contradictory in this regard, the ECJ's most recent dividend cases seem to emphasize a principle of source-country primacy (at least with respect to corporate-level taxes) in that greater constraints have been placed on residence countries.[129] As noted above, the Court also often analyses the corporate and shareholder taxes as separate levies. Putting those two tendencies together might lead to the conclusion that the results displayed in the Appendix roughly reflect the international tax system's assignment of the corporate tax to the source country and the investor tax to the residence country. From this perspective, *ACT Test Claimants* should not be read as precluding adoption by the ECJ of the result in *Fokus*, since the latter in-

127. For examples, see *St. Gobain*, *supra* note 43, paras. 56–57; *Bouanich*, *supra* note 72, paras. 49–50; *ACT Test Claimants*, *supra* note 88, paras. 52,79,81,85; *Denkavit*, *supra* note 115, paras. 32, 37, 43, 44.

128. A.G. Geelhoed proposed another set of rhetorical distinctions, but it has not been adopted by the Court. See *ACT Test Claimants*, *supra* note 88, Opinion of A.G. Geelhoed, paras. 36–57. In particular, "true" restrictions (violative of EC Treaty) are distinguished from "quasi" restrictions (not violative) due to administrative burdens, disparities (differences between tax systems) or division of the tax base (due to the overlapping jurisdiction of source and residence countries).

129. See also Case C-471/04, *Finanzamt Offenbach am Main-and* v. *Keller Holding Gmbtt*, [2006] ECR I-2107 (holding a residence country could not deny financing deductions for non-taxable dividends from a foreign subsidiary when such deductions were available for non-taxable dividends from domestic subsidiaries).

volved a shareholder, not a corporate, tax. This approach necessarily requires classification of tax attributes as relating to either corporate or shareholder taxation. Some of the Court's decisions seem to classify ACT as an attribute of corporate taxation, while others classify imputation credits and withholding as attributes of shareholder taxation. The fundamental conceptual problem with this approach is, as we have argued throughout this article, that corporate and shareholder taxes are inextricably related, because they are levied at different points on the flow of corporate income. Moreover, if these two tendencies are indeed responsible for the direction the Court is moving, the ECJ has failed to explain why source-country primacy and separation of corporate and shareholder taxation should be imposed on the Member States as a matter of judicial interpretation of the EC Treaty.[130] Nor can international tax practice be rationally invoked to prohibit legislation, such as that struck down in *Manninen* and *Meilicke*, which is clearly permitted under international tax practice.

Third, the summary of ECJ holdings above is generally consistent with the Parent-Subsidiary Directive in the sense that residence countries seem to bear a greater burden in reducing international double taxation of corporate-source income. But the Parent-Subsidiary Directive is a very limited, precise document, which provides no basis for the ECJ decisions involving, for example, individual shareholders. Indeed, as the Court has indicated, the Directive explicitly excludes imputation systems from its scope.[131] It is also worth emphasizing that the Parent-Subsidiary Directive, and the revisions to it, resulted from a lengthy political process that produced unanimous consent from the Member States.

Fourth, before *Manninen*, it might have been possible to argue that the Court was pursuing a principle favoured by some commentators, which would have restricted the discrimination inquiry to the tax situation in a single country.[132] A particularly stringent version of this approach would determine whether a taxing provision is neutral with respect to incoming and

130. Cf. Wattel, "Corporate tax jurisdiction in the EU with respect to branches and subsidiaries", 12 *EC Tax Review* (2003), 194, 199, arguing that there is no basis for source-country entitlement in the EC Treaty.

131. Art. 7.

132. See e.g. Roxan, "Assuring Real Freedom of Movement in EU Direct Taxation", 63 MLR (2000), 831, 873, proposing a cross-migration framework for identifying prohibited taxation of transborder income; Schön, "Tax Competition in Europe the Legal Perspective", 9 *EC Tax Review* (2000), 90, 97–99, arguing that the EC Treaty requires only that a country establish capital import neutrality within its borders and "not unreasonably hinder" exportation of capital, whether monetary, real, or human; Van Thiel, "The future of the principle of non-discrimination in the EU: Towards a right to the most favored nation treatment and a prohibition of double burdens?", in Avi-Yonah, Hines and Lang, op. cit. *supra* note 112.

outgoing investment on the assumption that both countries have the same tax system and rates.[133] At least since *Manninen*, however, the Court has been willing to look beyond the borders of the litigating Member State in considering income tax provisions.[134]

Finally, some might be tempted to read the decisions as serving the Commission's campaign to harmonize Europe's corporate tax provisions. On this view, the invalidation of national tax provisions by the ECJ facilitates their later harmonization by the Commission. Deciding cases with this goal in mind would obviously exceed the Court's judicial role as arbiter of the EC Treaty. We see no reason to impugn the professionalism of the ECJ, nor any evidence that the Court considers itself a mere amanuensis of the Commission in these decisions.[135]

In the end, we can identify no principled basis for the array of decisions discussed in this article.[136] We are thus left with the explanation that the ECJ, encouraged by the Commission, has embarked on a mission to require non-

133. See e.g. Van den Tempel Report, *supra* note 13, at 37. This approach is similar to the "internal consistency test" sometimes applied by the U.S. Supreme Court to determine whether state tax laws are discriminatory. For an argument that the ECJ should replace its comparable internal situation test with the Supreme Court's version of internal consistency, see Mason, *supra* note 48; see also Kufer and Mason, "Kerckhaert and Morres: A European 'Switch in Time'?" 14 CJEL (forthcoming, 2007), applying internal consistency to argue that *Kerckhaert* was wrongly decided; Hellerstein, "Is 'internal consistency' dead?: Reflections on an evolving commerce clause restraint on state taxation", 61 *Tax Law Review* (forthcoming, 2007), tracing the development of the internal consistency test in the US Supreme Court.

134. The Court has also looked beyond the litigating Member State in non-dividend income tax cases. See e.g. Case C-446/03, *Marks & Spencer plc* v. *David Halsey (HM Inspector of Taxes)* [2005] ECR I-10837, holding that whether a residence country had to allow deduction of losses of foreign subsidiaries against income of a domestic parent company depended on the treatment of those losses in the source country; Case C-279/93, *Finanzamt Köln-Alstadt* v. *Roland Schumacker*, [1995] ECR I-225, German taxation of income of Belgian non-resident had to take into account total income.

135. The Court's dividend decisions, including *ACT Test Claimants*, are generally consistent with the views expressed by the Commissions' representative before the ECJ. On the other hand, COM(2003)810, *supra* note 68, at 3.2.4, suggests that the Commission would regard *Kerckhaert* as wrongly decided. The Commission also argued that the legislation in *Fokus* violated the fundamental freedoms, a position that the ECJ has not rushed to endorse. Report for the Hearing, EFTA Case E-1/04, *Fokus*, paras. 48–55.

136. Kingston, op. cit. *supra* note 1, offers a much more positive view of the ECJ's decisions in some of these cases. She suggests, for example, that *ACT Test Claimants* can be distinguished from *FII Test Claimants* on the ground that the UK chose to tax the (inbound) dividend in the latter, but not the (outbound) dividend in the former; id. 1339–1341. Similarly, she suggests that *Kerckhaert* can be distinguished from *Denkavit* on the ground that the (inbound) dividend in the former was subject to only one layer of tax in the source country; id. at 1341–1343. From our perspective, these distinctions are flawed, because they depend on separate consideration of corporation and shareholder taxes. From a tax policy perspective, such taxes should be regarded as alternative levies imposed at different stages on the flow of corporate income.

discrimination on the basis of both the origin and the destination of corporate investments yielding dividends. As we demonstrated in our earlier article, this is ultimately an impossible task in the absence of fully harmonized income taxes throughout Europe. Not surprisingly, the Court has retreated somewhat and seems to have found that it had to choose between the two criteria. In some of the dividend cases, it seems to have chosen the latter by imposing higher burdens on residence countries. But there are no grounds for that choice in the EC Treaty, nor has the Court articulated any.

Our conclusion is thus that the Court's dividend jurisprudence fails to hold together substantively, functionally and rhetorically. Substantively, there is no basis in the EC Treaty for choosing source over residence taxation (if the Court has indeed made that choice). Functionally similar tax provisions, such as withholding and imputation, are treated differently, due to the Court's insistence on a formalistic distinction between taxes on corporations and shareholders. Rhetorically, the categories used by the ECJ (comparability, allocation versus exercise of taxing jurisdiction, and so on) are so malleable that they provide very little predictive power as to how future cases will be decided.

As we indicated at the beginning of this article, formulating a system for the taxation of cross-border dividends is a very difficult tax policy enterprise, given the myriad of factors that must be addressed. At a minimum, the ECJ's response demonstrates the inadequacy of using a single criterion, such as non-discrimination, as the exclusive touchstone for such a formulation.

Appendix

ECJ Dividend Cases		
	Outbound Dividends	**Inbound Dividends**
Member State Involved	Source country	Residence country
Potential Basis for Discrimination	Origin of investment	Destination of investment
Potential Neutrality Standard	Capital import neutrality	Capital export neutrality
Cases Involving Individual Shareholders	Fokus (2004) [EFTA Court]: shareholder imputation credit must be extended to foreign shareholders Bouanich (2006): capital gain taxation of redemptions must be extended to foreign shareholders	Verkooijen (2000): exemption must be extended to foreign dividends Lenz (2004): lower rate must be extended to foreign dividends Manninen (2004); Meilicke (2007): shareholder imputation credit must be extended to foreign dividends Kerckhaert (2006): foreign withholding tax on dividends need not be credited
Cases Involving Corporate Shareholders	Avoir Fiscal (1986): shareholder credits must be extended to foreign permanent establishments Metallgesellschaft (2001): ACT exemption must be extended to dividends paid to foreign parents ACT Test Claimants (2006): shareholder imputation credit need not be extended to foreign parents Denkavit (2006): withholding exemption must be extended to foreign parents	St. Gobain (1999): treaty exemption for dividends and indirect foreign tax credit must be extended to foreign permanent establishments FII Test Claimants (2006): ACT exemption and shareholder imputation tax credit must be extended to foreign dividends