

Comparative Fiscal Federalism

What Can the U.S. Supreme Court and the European Court of Justice Learn from Each Other's Tax Jurisprudence?

By Reuven S. Avi-Yonah

In October 2005, a group of distinguished tax experts from the European Union and the United States, who had never met before, convened at the University of Michigan Law School for a conference on "Comparative Fiscal Federalism: Comparing the U.S. Supreme Court and European Court of Justice Tax Jurisprudence." The purpose of the conference was to shed comparative light on the very different approaches taken by the European Court of Justice (ECJ) and the U.S. Supreme Court to the question of fiscal federalism. The conference was sponsored by the U-M Law School, U-M's European Union Center, and Harvard Law School's Fund for Tax and Fiscal Research.¹

The impetus for the conference, the first of its kind, was a series of ECJ decisions in the last 20 years, but with increasing frequency in the last five. In those decisions the ECJ interpreted the Treaty of Rome (the "constitution" of the EU) aggressively to strike down numerous Member State income tax rules on the ground that they were discriminatory. For example, the ECJ ruled that Finland cannot grant tax credits for corporate tax paid to Finnish shareholders, but refuse them to foreign shareholders. In another case, the ECJ struck down Germany's rules that restricted the deductibility of interest to foreign lenders, even though the rules also applied to tax-exempt domestic lenders. Other examples of provisions struck down by the ECJ are:

- a dividend tax credit granted to resident companies but refused to the branch of a company having its seat in another Member State;
- a refund of overpaid income tax granted to permanent residents but refused to taxpayers moving to another Member State during the tax year;
- personal reliefs granted to residents but refused to non-residents even where they could not benefit from such reliefs in their Member State of residence;
- a business relief (a tax deduction for transfers of funds to a pension reserve) granted to residents but refused to non-residents.

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

On the face of it, this contrast is surprising. After all, the ECJ is dealing with fully sovereign countries, and taxation is one of the primary attributes of sovereignty. Moreover, the authority of the ECJ

to strike down Member State direct taxes is unclear. The Treaty of Rome generally reserves competence in direct taxation to the Member States, and all EU-wide changes in direct taxation have to be approved unanimously by all 25 Member States. Nevertheless, the ECJ has since the 1980s interpreted the "four freedoms" embodied in the Treaty of Rome (free movement of goods, services, persons and capital) to give it the authority to strike down direct tax measures that it views as incompatible with the freedoms.

The Supreme Court, on the other hand, has clear authority under the Supremacy Clause to strike down state laws that are incompatible with the Constitution. As Justice Oliver Wendell Holmes observed, the U.S. will not be hurt if the power to review federal laws were taken away from the Court, but it could not survive if the Court lost its power over state legislation. Moreover, the states are not fully sovereign and are not even directly represented in Congress, so that the Court could strike down their laws without (in most cases) expecting an outcry from the other branches of the federal government.

What is the explanation for the contrast? Part of the reason is that Member State taxes in the EU are more important than state taxes in the U.S., because most taxes in the U.S. are paid to the federal government, whereas all taxes in the EU are paid to Member States. Thus, even high tax states like New York or California have income tax rates in the low double digits, whereas Member State tax rates can reach 40 percent (for corporations) and 60 percent (for individuals).

However, this cannot be the whole answer, because the U.S. Supreme Court adopted its lenient attitude to state taxation before there were federal taxes; the federal corporate tax only began in 1909, and the federal income tax in 1913, long after the states began taxing income. Instead, the answer lies in different conceptions of federalism.

In the U.S., federalism means that the federal government should respect the sovereignty of the states as much as is compatible with the need to have a unified country. Taxes are essential to sovereignty, and therefore the Supreme Court has always maintained a deferential attitude to state choices in matters of taxation, even if it resulted in some level of discrimination against out-of-staters. The Court intervenes only when the tax is blatantly discriminatory, such as New Hampshire's attempt to adopt an income tax only for non-residents who commute into the state.

In the EU, on the other hand, there is no unified central government. However, the ECJ has taken the lead in trying to create a meaningful single market. It, and the EU Commission (which brings many of the tax cases before the ECJ), see discrimination in direct tax matters as a major obstacle to the achievement of this goal. Ultimately, many observers feel that the ECJ is trying to force Member States to abandon the unanimity rule for direct tax matters and even to achieve direct tax harmonization, such as the harmonization already used for indirect taxes; consumption taxes, such as VAT, are harmonized in the EU by the Sixth Directive, adopted by unanimous consent when the EU was much smaller.

Given this divergence of political context, can the ECJ and the Supreme Court learn something from each other's tax jurisprudence? I believe the answer is yes, and that the conference showed some of the lessons each can learn from the other.

For the U.S. Supreme Court, I believe the EU experience shows that it is sometimes too lenient in state tax matters. In

particular, permitting states to compete for the location of investment by multinationals by granting tax incentives has proven to be very costly for the states, while not bringing any benefit to the U.S. as a whole (since the multinational typically has decided to invest somewhere in the U.S. already). Such tax competition creates a "race to the bottom," in which states only grant incentives to prevent the multinational from going elsewhere, not because they believe the benefits of the investment truly justify the cost in foregone tax revenue. In Europe, such incentives are banned by the State Aid provisions of the Treaty of Rome, which are strictly interpreted by the Commission and the ECJ to prohibit all tax incentives that are targeted at particular taxpayers.

Fortunately, the Supreme Court has just accepted a case from Ohio that raises this issue directly. In 1998, the City of Toledo granted DaimlerChrysler \$280 million in tax incentives to expand its factory there, rather than move it to Michigan or elsewhere in the U.S. The Sixth Circuit Court of Appeals in *Cuno v. DaimlerChrysler* held that such targeted tax incentives violate the Commerce Clause of the U.S. Constitution. If the Supreme Court is willing to learn from the ECJ in this regard, it should affirm that decision.

What about the ECJ learning from the Supreme Court? Here as well, a pending case can offer a learning opportunity. In *Marks and Spencer*, the issue is whether the U.K. is obligated to allow losses incurred by Marks & Spencer's foreign subsidiaries to offset income earned by the U.K. parent, because under U.K. rules it can use losses by domestic subsidiaries to offset income of the parent. The big difference, of course, is that the domestic subsidiaries are subject to tax at the same rate as the parent, while the foreign subsidiaries can be in Estonia, where there is no corporate tax, or in Ireland, where the tax rate is only 12.5 percent. If the ECJ rules that the U.K. must allow the loss offsets even though it cannot tax the foreign subsidiaries, as Advocate General Maduro has ruled in his preliminary opinion, it is widely expected that the corporate tax base in all high-tax Member States will disappear.

If the ECJ accepts Maduro's opinion, it is likely that it will do so in order to force the political branches of the EU to move toward corporate tax rate harmonization, as the Commission has advocated (to no avail) for many years. But here the ECJ can learn a lesson from the U.S. Supreme Court: deciding cases in order to force action by the legislature can be dangerous.

This rule can be illustrated by the *Quill* case, decided by the Supreme Court in 1991. The case involved a question that had confronted the Court before: under what circumstances can a state force retailers that sell into the state by remote means, such as catalogues or (nowadays) via the Internet, to collect the sales tax due on the purchases? The tax is clearly due, but relying on the buyers to pay it voluntarily is hopeless, so collection by the remote vendor is the only practical way to collect the tax.

In 1967, the Court held that the vendor cannot be made to collect the tax unless it had a physical presence (like a warehouse) in the state, relying on both the Due Process and Commerce Clauses of the Constitution. Most observers expected when the Court accepted the *Quill* case that it will overturn that decision, given the phenomenal growth of the remote sales industry between 1967 and 1991. Instead, the Court held that the physical presence test still applies, but only under the Commerce Clause, not the Due Process clause.

The reason the Court adopted this approach is clear: Commerce Clause decisions can be changed by Congress through simple legislation, since the Constitution gives Congress the power to regulate commerce among the states, but Congress is powerless to overcome decisions under the Due Process Clause. The Court thus expected Congress to intervene and set rules under which states can force remote vendors to collect sales taxes.

Fourteen years have passed, and Congress has not acted. The reason is simple: the states are not represented in Congress, so Congress cares more about the remote sales industry with its powerful lobby than about state tax revenues. In the meantime, the Internet has sprung into existence, remote sales now top \$100 billion per year, and state sales tax revenues are rapidly shrinking.

The lesson for the ECJ is thus not to decide cases in the expectation that the political branches will act. Many Member States are vehemently opposed to direct tax harmonization. The U.K., for example, is more likely to react to losing *Marks and Spencer* by abolishing its domestic loss offset rules than by giving up on the unanimity requirement in direct taxes. Thus, the lesson for the ECJ is that it should accept that foreign subsidiaries are different from domestic ones because they are not subject to home country tax, and reverse the Advocate General's opinion.

More broadly, I believe comparing the U.S. and EU experiences shows that there is more than one way of constructing a single market without tax distortions, and that some level of distortion can be accepted. Thus, the U.S. Supreme Court can afford to be a bit harsher without trampling down on state sovereignty on tax matters, and the ECJ can afford to be more lenient without creating unacceptable barriers to trade and investment within the EU.

I hope this conference is just the beginning of a series of discussions between EU and U.S. tax experts on these issues. A conference volume will be published next year, and a follow-up conference is tentatively scheduled for 2007—by which time we will at least know how *Cuno* and *Marks and Spencer* came out.

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¹ Attendees from Europe included Michel Aujean, the principal tax official at the EU Commission; Servaas van Thiel, chief tax advisor to the EU Council; Michael Lang (Vienna) and Kees van Raad (Leiden), who run the two largest tax LL.M. programs on the European continent; and many other distinguished guests. The U.S. contingent included Michael Graetz of Yale Law School, Alvin Warren of Harvard Law School, Walter Hellerstein of the University of Georgia (widely recognized as the preeminent U.S. state tax scholar), and other important academics. Michigan was represented by Kyle Logue and Daniel Halberstam of the Law School, Jim Hines of the Department of Economics, and me as conference organizer.