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COMMON MARKETS, COMMON TAX PROBLEMS

by

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COMMON MARKETS, COMMON TAX PROBLEMS*by**Ruth Mason**

It began with George Washington himself, when he wrote to Lafayette:

I am a citizen of the greatest Republic of Mankind. I see the human race united like a huge family by brotherly ties. We have made a sowing of liberty which will, little by little, spring up across the whole world. One day, on the model of the United States of America, a United States of Europe will come into being. The United States will legislate for all its nationalities.¹

I. INTRODUCTION

The United States and the European Union are different in more ways than it is possible to briefly enumerate, but their foundations had a striking similarity of purpose: to increase citizens' welfare by uniting a collection of independent states, each with its own politics, culture, and economy. Of course, the unification of the U.S. states – never as divided politically, culturally, or economically as the countries of Europe – is an achievement largely in the past. In contrast, significant integration in Europe has taken place in our own time. Although the United States and the European Union have similar goals, the political structure and degree of unification differ substantially in each region. The United States is a single country, with a unified polity and a powerful central government, whereas the European Union is a collection of 27

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1. André Fontaine, *Open Democracy, Farewell to the United States of Europe: long live the EU!*, (2001), available at http://www.opendemocracy.net/democracy-europefuture/article_344.jsp.

independent countries and peoples with a weak central government.² The purpose of this Essay is to explore the common tax problems confronting the U.S. and European Union (EU) common markets.

The degree of independence of the central government from the states differs in the United States and the European Union. The U.S. central government is largely independent of the states. Although the federal Congress includes two Senators from each state, the citizens of the states directly elect the Senators, who represent the people's interests, rather than the interests of the states, *per se*. Representation in the House of Representatives is proportional to population, and Representatives are also directly elected by residents each of Congressional district. In contrast, the EU central government is much less independent from the Member States. Although the European Union has a directly elected Parliament, the European Parliament has little power. Most of the central government's power is concentrated in the Council of the European Union, composed of ministers of the Member States.³ Such ministers are often unelected members of the national government of the Member States, and therefore may be seen as representing the interests of the government of their Member State more than the interests of the residents of that state.

Further differences can be seen in each region's tax system. As the *quid pro quo* of a strong central government, the power to levy taxes is Congress's first enumerated power in the Constitution.⁴ The U.S. federal government collects taxes from individuals and other taxable entities according to uniform federal laws that apply throughout the geographic territory of the United States. Albeit not legally reserved to the states, the sales tax base is reserved to the states by tradition, and sales and property taxes constitute the source of the majority of state and local tax revenue.⁵ Although the U.S. states have tax authority independent from the federal government, the federal government is

2. See Walter Hellerstein & Charles E. McLure Jr., *Lost in Translation: Contextual Considerations in Evaluating the Relevance of the U.S. Experience for the European Commission's Company Taxation Proposals*, 58 *Bull. Int'l Bureau Fiscal Doc.* 86, 88 (2004) ("the EU follows more closely the confederation model, with decisions being made jointly by the Member States rather than by a higher level of government, which barely exists and, contrary to the situation in the US, has little power"). But see Ingolf Pernice, *The Framework Revisited: Constitutional, Federal and Subsidiarity Issues*, 2 *Colum. J. Eur. L.* 403, 413 (1996) (arguing that the "financial weakness" of the Community obscures a significant source of its power: its unfettered ability to regulate by unfunded mandate to the Member States).

3. For tax purposes, the European Council consists of the finance minister of each Member State. For more on the EC tax legislative process, see Ruth Mason, *Primer on Direct Taxation in the European Union 4-14* (2005) [hereinafter *Mason, Primer*].

4. U.S. Const. Art. I, § 8, cl. 1.

5. See Report of the President's Tax Advisory Panel on Federal Tax Reform, *Simple, Fair, and Pro-Growth: Proposals to Fix America's Tax System 202* (2005) (noting that a likely obstacle to adoption of a federal value-added tax was that states would view it as "an intrusion on their traditional sales tax base").

the big player in American taxation: it annually raises twice the taxes raised by all the U.S. states combined.⁶

The European Community itself exercises almost no tax authority,⁷ although it is guaranteed a certain percentage of value-added tax revenues and other funding⁸ in the form of transfers from the Member States.⁹ Since the EC Treaty grants no explicit tax powers to the European Union, the Member States are the principal taxing authorities. Moreover, the requirement of Member State unanimity to enact Community tax legislation ensures that taxation will remain under the control of the Member States indefinitely.¹⁰ Likewise, the principle of “subsidiarity,” which forbids action at the EU level except when the policy objective cannot be achieved at the state level, also suggests that the Member States will remain the principal actors for tax matters.¹¹

Member States assess and collect both direct and indirect taxes, and in contrast with the United States (where the largest source of federal revenue is income and payroll taxes) in Europe, indirect taxes represent a substantial source of national tax revenue. Value-added taxes have been largely harmonized in the European Union, but income taxes are unharmonized, leaving each state

6. See U.S. Census Bureau, *Census of Governments* (calculating combined state and local tax revenues for fiscal year 2002 at nearly \$1 trillion); Office of Management & Budget, *Budget of the U.S. Government* (calculating 2002 federal revenues at over \$1.8 trillion).

7. The Community levies income taxes on its own employees, who are exempt in their home states from income tax on their Community government wages. It also collects levies on coal and steel.

8. The European Union’s non-debt funding derives principally from: (1) duties on coal and steel and imposts collected for the purpose of enforcing the Common Agricultural Policy, (2) a fixed percentage of the VAT revenues collected by each state, (3) contributions by each Member State of a fixed percentage of its gross national income (GNI). See Sijbren Cnossen, *Tax Policy in the European Union: A Review of Issues and Options* (CESifo, Working Paper No. 758, 2002) available at http://ideas.repec.org/p/ces/ceswps/_758.html; Lerke Osterloh, *Harmonization and Public Finance in Germany and Europe*, 2 *Colum. J. Eur. Law* 519 (1996). The percentage contributions have varied over time, but the EU budget is small relative to the Member States’ national budgets. The latest agreement capped the European Union’s own resources at 1.24% of the GNI of the European Union. See *Communication from the Commission to the Council and the European Parliament, Adaption of the Ceiling of Own Resources and of the Ceiling for Appropriations for Commitments Following the Entry Into Force of Decisions 2000/597/EC*, Eurotom, COM (2001) 811 final.

9. See *The Consolidated Version of the Treaty Establishing the European Community*, Art. 268-280, Dec. 29, 2006, 2006 O.J. (C 321) E/1 [hereinafter *EC Treaty*] (setting forth fiscal and budgetary rules, and stating that the European Union’s “budget shall be financed wholly from own resources,” but not conferring on any EU institution the positive right to tax).

10. *Id.*, Art. 94.

11. *Id.*, Art. 5.

free to determine both the rates of tax and the taxable base. As a result, a resident of France with the same income from the same sources as a resident of Estonia may be subject to vastly different taxes. While the federal government collects two-thirds of annual taxes in the United States, in Europe, the Member States collect virtually all taxes.¹²

Notably, the formation of the United States predated the advent of the state income taxes,¹³ whereas Member State tax systems were in place well before the formation of the European Union. This difference may affect the degree of resistance in each region to involvement by the central government in state tax policy.

Despite these differences in the structure of government and the division of tax powers, certain tax issues in the United States and the European Union are similar. These include questions of horizontal federalism involving how membership in the common market affects the interaction of the states with each other and with each other's residents. For example, both the EC Treaty and the U.S. Constitution have been interpreted to ban discriminatory taxation by the states. This means that states generally cannot treat interstate or intra-Community commerce worse for tax purposes than they treat purely domestic commerce. The ban on discriminatory state taxation represents a significant constraint on state tax power.

Additionally, since neither the U.S. states nor the EU Member States entirely surrendered their tax sovereignty when joining their respective unions, vertical federalism questions also arise concerning which level of government is better suited or legally entitled to engage in certain tax functions.¹⁴ In the European Union, which is not a true fiscal federal system,¹⁵ and in which the central government has virtually no tax powers and a relatively small budget, vertical federalism questions principally concern such issues as whether the Member States should negotiate bilateral tax treaties directly with each other and third countries, or whether that task should be performed by the

12. Much of the budget of the European Union is pre-committed to agricultural subsidies. See references in *supra* note 8.

13. See Hellerstein & McLure, *supra* note 2, 96-98 (discussing what they call the "implications of nationhood" on the limits of the comparison between U.S. state taxation and EU Member State taxation).

14. For more on tax assignment and fiscal federalism issues generally, see Robert P. Inman & Daniel L. Rubinfeld, *Designing Tax Policy in Federalist Economies: An Overview*, 60 *J. Pub. Econ.* 307 (1996).

15. In 1996, Professor Lerke Osterloh recounted French President Jacques Chirac's view that "the Union is neither a federation in the German sense nor simply a free-trade area as the British government wishes, and some aspects of the fiscal constitution, but not all of them, seem to confirm this statement." Osterloh, *supra* note 8, at 521. Osterloh concluded that "the tax laws within the EU are characteristic more of a free trade zone than a federation." *Id.* at 529.

Community, which could negotiate bilateral tax treaties with third countries on behalf of the whole European Union.

The U.S. and EU states also share challenges facing any state operating in a multi-jurisdictional tax setting. Among these challenges are tax competition, allocation of taxable income in light of the fact that the geographic “source” of an item of income may be uncertain, and avoidance of double taxation. These challenges may be especially acute in the U.S. and EU common markets due to extensive interstate investment and economic activity.¹⁶

The purpose of this Essay is to identify some of the tax problems common to both the United States and the European Union and to explore potential solutions. As the length of the Essay suggests, I do not purport to discuss comprehensively each topic, or to cover every tax challenge common to the United States and European Union.¹⁷ Instead, my hope is that this Essay will become part of the ongoing trans-Atlantic dialog concerning our common tax problems and solutions that may work in both places.¹⁸ Of course, the significant differences between the United States and the European Union mean that tax lessons learned in one jurisdiction may only be applied in the other with considerable caution.¹⁹

16. Cf. Daniel Shaviro, *An Economic and Political Look at Federalism in Taxation*, 90 Mich. L. Rev. 895 (1992) (arguing that the greater elasticity of response to locational tax disparities in the modern United States, as compared to the early United States, means that inefficiencies caused by discriminatory taxes are more important today).

17. Although not covered in this Essay, many other tax challenges common to both regions come to mind, including the treatment of cross-border dividends, cross-border loss relief, dispute resolution mechanisms for unresolved cases of double taxation, compliance issues, taxation of electronic commerce, and so on. Of particular interest in the United States might be the European success at harmonizing indirect taxes.

18. See, e.g., Martin Sullivan, *Lessons from Europe on State Corporate Taxes*, 40 State Tax Notes 407 (2006); Hellerstein & McLure, *supra* note 2.

19. See Hellerstein & McLure, *supra* note 2, at 89 (noting characteristics that tend to make U.S. state taxation – and consequently, its defects – less significant than EU Member State taxation, including such factors as diffusion of state tax benefits through the system of formulary apportionment, relatively low state income tax rates, and deductibility of state taxes from the federal tax base).

II. COMMON TAX PROBLEMS

A. State Tax Discrimination

Probably the tax area in which the United States and the European Union most resemble each other is the prohibition of state tax discrimination.²⁰ Both common markets ban tax discrimination by one state against residents of a fellow state.²¹ In the United States, the Constitution prohibits discriminatory state taxes under the Commerce, Privileges and Immunities, and Equal Protection Clauses.²² Of these provisions, the Commerce Clause has the broadest implications for state taxation.²³ Under the Supreme Court's "dormant" Commerce Clause jurisprudence, the states may not use their tax systems to unjustifiably burden or discriminate against interstate or foreign commerce.²⁴ Likewise, the European Court of Justice (ECJ) has interpreted the fundamental freedoms of the EC Treaty to prohibit discriminatory Member State taxes.²⁵

Unfortunately, neither Court has given clear guidelines as to what constitutes tax discrimination. In both jurisdictions, the basic features of a discriminatory tax are the same: the state favors domestic economic activities over out-of-state activities. Discrimination may also occur when a state

20. See generally Comparative Fiscal Federalism: Comparing the Court of Justice and the U.S. Supreme Court's Tax Jurisprudence (Reuven Avi-Yonah, James R. Hines, Jr. & Michael Lang eds., 2007).

21. For comprehensive analysis of U.S. state taxation, see Jerome R. Hellerstein & Walter Hellerstein, *State Taxation* (3d. ed. 1999 & Supp. 2007). For concise analysis of direct taxation in the European Union, see Mason, *Primer*, supra note 3. For comprehensive analysis of direct and indirect taxation in the European Union, see B. J. M. Terra & Peter Wattel, *European Tax Law* (2005); Paul Farmer & Richard Lyal, *EC Tax Law* (1995).

22. See Hellerstein & Hellerstein, supra note 21.

23. U.S. Const. Art. I, § 8, cl. 3, provides "Congress shall have Power... [t]o regulate Commerce with foreign Nations, and among the several States, and with the Indian Tribes." Compare the Privileges and Immunities Clause, which only applies to natural persons who are U.S. citizens. See U.S. Const. Art. IV, § 2, providing that "[t]he Citizens of each State shall be entitled to all Privileges and Immunities of Citizens in the several States" (emphasis added).

24. See, e.g., *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1997).

25. EC Treaty, supra note 9, Art. 39 (freedom of movement of workers), Arts. 43, 48 (freedom of establishment), Art. 49 (freedom to provide services), Arts. 56, 58 (freedom of capital movement). Article 49 of the EC Treaty provides for the freedom to provide services with the following language:

Within the framework of the provisions set out below, restrictions on freedom to provide services within the Community shall be prohibited in respect of nationals of Member States who are established in a State of the Community other than that of the person for whom the services are intended.

differentiates between resident and nonresident taxpayers and either singles out nonresidents for worse tax treatment, or singles out residents for special tax benefits.²⁶ However, in neither jurisdiction is a mere difference in taxation of domestic and cross-border situations sufficient to prove discrimination. This is so because the Supreme Court and the ECJ each recognize a variety of circumstances that justify different treatment for domestic and cross-border situations. The most important limitation on the scope of discrimination is the requirement of comparability. Under the jurisprudence of both Courts, states must treat domestic and cross-border situations the same for tax purposes only when the domestic and cross-border situations are “similar.”²⁷

Both courts have been criticized for giving insufficient content to the notion of “similar” tax situations.²⁸ Failure by both courts to articulate clear standards by which state taxes will be judged has led to significant legal uncertainty for taxpayers, states, and other courts bound by the Supreme Court’s and the ECJ’s judgments.²⁹ The Supreme Court has even criticized its own dormant Commerce Clause jurisprudence in tax discrimination cases, calling it a “quagmire” and a “tangled underbrush.”³⁰

Perhaps due to the difficulties in identifying tax discrimination, commentators’ recommendations concerning the future of judicial review of state taxes in each jurisdiction span a wide spectrum. Some say the courts

26. For more on the standards applied in tax discrimination cases in the United States and the European Union, see the references cited *supra* note 21.

27. See Case C-279/93, *Finanzamt Köln-Altstadt v. Schumacker*, 1995 E.C.R. I-225, ¶ 30 (“discrimination can arise only through the application of different rules to comparable situations or the application of the same rule to different situations”). Cf. *Lunding v. N.Y. Tax Appeals Tribunal*, 522 U.S. 287, 311 (1998) (using the term “similarly situated residents” in a tax discrimination case disposed under the Privileges and Immunities Clause).

28. For criticism of U.S. jurisprudence, see Edward A. Zelinsky, *Restoring Politics to the Commerce Clause: The Case for Abandoning the Dormant Commerce Clause Prohibition on Discriminatory Taxation*, 29 *Ohio N.U. L. Rev.* 29 (2002); Shaviro, *supra* note 16. For criticism of European jurisprudence, see Ruth Mason, *Flunking the ECJ’s Tax Discrimination Test*, 45 *Colum. J. Transnat’l L.* 72 (2008); Michael J. Graetz & Alvin C. Warren, Jr., *Income Tax Discrimination and the Political and Economic Integration of Europe*, 115 *Yale L. J.* 1186 (2006).

29. The Supreme Court itself acknowledged that its “case-by-case” approach under the dormant Commerce Clause “left much room for controversy and confusion and little in the way of precise guides to the States.” *Boston Stock Exch. v. State Tax Comm’n*, 429 U.S. 318, 329 (1977) (quoting *Northwestern States Portland Cement Co. v. Minnesota*, 358 U.S. 450, 457 (1959)).

30. *Northwestern States Portland Cement*, 358 U.S. at 457-8. See also *Wardair Canada, Inc. v. Florida Dept. of Revenue*, 477 U.S. 1, 17 (1986) (Burger, C. J., concurring in part and concurring in judgment) (referring to “the cloudy waters of this Court’s ‘dormant Commerce Clause’ doctrine”).

should expand their review of state taxes,³¹ others want to narrow it,³² and still others want to terminate it completely.³³ In the United States, the call to significantly restrict dormant Commerce Clause review of state taxes has come from members of the Court itself.³⁴ But despite widespread recognition of the

31. See, e.g., Peter D. Enrich, *Saving the States from Themselves: Commerce Clause Constraints on State Tax Incentives for Business*, 110 Harv. L. Rev. 377 (1996) (arguing that the Supreme Court should strike down certain business tax incentives offered by states under the dormant Commerce Clause). See also Servaas van Thiel, *A Slip of the European Court in the D Case (C-376/03): Denial of the Most-Favoured-Nation Treatment Because of Absence of Similarity?*, 33 Intertax 454 (2005) (arguing that the ECJ should interpret the fundamental freedoms to encompass a right of most-favored-nation treatment under tax treaties).

32. See, e.g., Shaviro, *supra* note 16 (arguing in favor of Congressional harmonization of state tax bases, which would have the effect of limiting judicial review of state taxes); Graetz & Warren, *supra* note 28 (arguing for judicial restraint in Europe).

33. Zelinsky, *supra* note 28 (arguing that the Supreme Court should abandon dormant Commerce Clause review of state taxes); cf. Julian N. Eule, *Laying the Dormant Commerce Clause to Rest*, 91 Yale L.J. 425 (1982) (suggesting that the Supreme Court abandon dormant Commerce Clause jurisprudence generally and instead rely on the Privileges and Immunities Clause to address discriminatory state regulations). See also Frans Vanistendael, *The ECJ at the Crossroads: Balancing Tax Sovereignty Against the Imperatives of the Single Market*, 46 Eur. Tax'n 413, 413 (2006) (noting that during negotiations for the proposed European Constitution, Member State representatives considered whether to strip the ECJ of direct tax jurisprudence).

34. Justice Scalia, never a fan of the dormant Commerce Clause, has harshly criticized the Court's majority opinions in tax discrimination cases. See, e.g., *Am. Trucking Ass'n, Inc. v. Smith*, 496 U.S. 167, 202 (1990) (Scalia, J., concurring) (noting his disagreement with the Court's "typically destabilizing" dormant Commerce Clause jurisprudence). In *Schneider*, Justice Scalia stated that he would only strike down state tax statutes that facially discriminate between residents and nonresidents. *Am. Trucking Ass'n, Inc. v. Scheiner*, 483 U.S. 266, 304 (1987) (Scalia, J., dissenting) ("The same tax is imposed on in-state as on out-of-state trucks; that is all I would require."). Justice Scalia has also argued that

the practical results we have educed from the so-called "negative" Commerce Clause form not a rock but a 'quagmire' Nor is this a recent liquefaction. The fact is that in the 114 years since the doctrine of the negative Commerce Clause was formally adopted as holding of this Court, . . . and in the 50 years prior to that in which it was alluded to in various dicta of the Court, . . . our applications of the doctrine have, not to put too fine a point on the matter, made no sense.

Tyler Pipe Indus., Inc. v. Wash. State Dep't of Revenue, 483 U.S. 232, 259-260 (1987) (Scalia, J., concurring in part and dissenting in part) (citations omitted). Justice Thomas has also criticized the Court's dormant Commerce Clause jurisprudence as "failed," a "morass," and "virtually unworkable in application," and he recommended abandoning it in tax cases in favor of scrutiny under the Import-Export Clause. See *Camps Newfound/Owatonna, Inc., v. Town of Harrison*, 520 U.S. 564, 610-611 (1997) (Thomas, J., dissenting).

problems with the judicial standards for state tax discrimination, surprisingly few concrete suggestions for improvement have been made in this area.³⁵

One solution to these problems might be to abandon judicial review of state taxes altogether. This could be accomplished in Europe by stripping the ECJ of its jurisdiction to review income tax cases. A suggestion to do just that was made during recent negotiations over the European Constitution.³⁶ However, the suggestion was not adopted in the final draft of the proposed Constitution, perhaps due to recognition of the important pro-integration role played by the Court of Justice in taxation. Since tax legislation in the European Union requires unanimous agreement by the Member States, there have been few legislative directives covering direct taxes.³⁷ Instead, most of the progress in removing tax barriers to cross-border trade and investment has resulted from tax cases brought in national courts by private litigants and referred to the ECJ for preliminary ruling.³⁸

Abandoning review of state taxes might be a better option for the United States. Unlike Europe, the United States is already so well-integrated politically and economically that perhaps tax discrimination is no longer a major problem.³⁹ While removal of discriminatory taxes may have been necessary at the formation of the Union, we might conclude that the Supreme Court's early vigilance served its purpose. However, successful state tax discrimination claims in the modern era, which articulate important principles and protections, tend to undermine the argument that review of state taxes is no longer necessary in the United States.⁴⁰

35. But see Ruth Mason, *Made in America for European Tax: The Internal Consistency Test*, 49 B.C. L. Rev. (forthcoming 2008) (suggesting that the ECJ apply the internal consistency test to income tax cases as a first step towards rationalizing its review of Member State taxes); for more on the internal consistency test, see *infra* text accompanying notes 62-64. See also Shaviro, *supra* note 16 (proposing that Congress harmonize the state tax base, leaving the states with authority only to determine their tax rates).

36. See Vanistendael, *supra* note 33, at 413.

37. EC Treaty, *supra* note 9, Art. 94.

38. See Servaas van Thiel, *Removal of Income Tax Barriers to Market Integration in the European Union: Litigation by the Community Citizen Instead of Harmonization by the Community Legislature?* 12 EC Tax Rev. 4 (2003) (arguing that, jealous of their national tax sovereignty, the Member States have blocked tax legislation at the Community level).

39. See Zelinsky, *supra* note 28, at 31 (calling the nondiscrimination principle as applied to state taxes "a historic anachronism, now unnecessary for policing state taxes").

40. See, e.g., *Camps Newfound/Owatonna, Inc., v. Town of Harrison*, 520 U.S. 564 (1997) (holding that a state could not deny property tax exemptions to charities that served out-of-state residents when it granted such exemptions to charities serving state residents); *West Lynn Creamery, Inc. v. Healy*, 512 U.S. 186 (1994) (holding that a state could not "conjoin" a nondiscriminatory tax assessed on both in-state and out-of-

Moreover, it is difficult to say how U.S. courts could completely avoid review of state taxes. Even in the unlikely scenario that Justices Scalia and Thomas convinced the rest of the Court to abandon dormant Commerce Clause review of state taxes, tax discrimination has frequently been held to violate the Privileges and Immunities Clause⁴¹ and, in a few cases, the Equal Protection Clause.⁴² Due to the obligation to review state taxes under those provisions, federal courts would have to apply some conception of tax discrimination, even if they did not review state taxes under the dormant Commerce Clause.⁴³ Of course, one important difference between the Supreme Court and the ECJ is that the Supreme Court can choose which cases it hears. The Supreme Court is notoriously parsimonious in granting certiorari in tax cases,⁴⁴ and this reluctance to hear tax cases may help achieve the same effect urged by those who would like the Court to narrow or abandon its review of state taxes. Still, lower courts in the United States also perform judicial review, and they have much less control over their dockets.

Another option might be to transfer the review function to another government institution. Perhaps review of state taxes could be performed by a federal agency in the United States or the Commission in Europe. Commentators have also suggested that the review function could be performed by the state or central legislature.⁴⁵ However, transferring competence to review state taxes from the courts to another government institution would not solve the

state interests with a subsidy to in-state interests that had the effect of rebating the tax only to in-state interests); *Container Corp. of Am. v. Franchise Tax Bd.*, 463 U.S. 159 (1983) (establishing the internal consistency test and the four-part test for reviewing state taxes under the Commerce Clause).

41. See, e.g., *Lunding v. N.Y. Tax Appeals Tribunal*, 522 U.S. 287 (1998); *Travis v. Yale & Towne Mfg. Co.*, 252 U.S. 60 (1920).

42. See, e.g., *Metropolitan Life Ins. Co. v. Ward*, 470 U.S. 869 (1985).

43. Professor Zelinsky suggests that, if the Supreme Court were to adopt his proposal to abandon dormant Commerce Clause review of state taxes, taxpayers who felt they were victims of tax discrimination “should generally take their complaints to Congress or to the legislature levying those taxes.” Zelinsky, *supra* note 28, at 88. However, he envisions that courts would still review state taxes under the Privileges and Immunities Clause and the three *Complete Auto* factors not dealing with discrimination: nexus, fair apportionment, and reasonable relation to the government services provided. *Id.* at 83 (citing *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977)). Review of state taxes under Privileges and Immunities requires courts to develop and apply a conception of tax discrimination.

44. *Bob Woodward & Scott Armstrong, The Brethren* 362 (1979) (noting that Justice Brennan’s typical reaction to a certiorari request in a tax case was, “This is a tax case. Deny.”).

45. See, e.g., Shaviro *supra* note 16, at 954 (briefly considering and rejecting the notion that Congress would do a case-by-case review of state taxes); cf. Zelinsky, *supra* note 28, at 88 (arguing that aggrieved taxpayers should seek legislative repeal of discriminatory taxes).

difficult problem of clearly defining what constitutes tax discrimination. Moreover, political economy analysis suggests reasons why judicial review may have certain advantages over review by other institutions. Under the current systems in the United States and the European Union, taxpayers initiate constitutional challenges to state taxes. A taxpayer, who typically bears legal costs for lost cases, may be more efficient than government agencies at choosing which state taxes to challenge.⁴⁶

Additionally, by bringing such challenges, the taxpayer becomes an effective co-enforcer of the ban on discriminatory taxes. In contrast, relying solely on governmental institutions, such as Congress, a federal administrative agency, or the European Commission, to root out tax discrimination may be less effective than private enforcement due to the possibility that those institutions could be captured by the states. The European Commission is already empowered to challenge Member State laws before the ECJ, but it has brought very few tax challenges. Private litigants' high ratio of success in tax cases suggests that there are gaps in the Commission's enforcement of the ban on Member State tax discrimination. The Commission even acknowledged its own lack of zealous advocacy when it resolved in 2001 to bring more tax cases before the ECJ.⁴⁷ Likewise, there is significant evidence that Congress is reluctant to interfere with state taxes.⁴⁸

46. Some parties in Europe and the United States have brought multiple challenges to state tax legislation. See, e.g., references to cases brought in the United States by American Trucking Associations in *supra* note 34. See also Joined Cases C-283/94, C291/94 and C-292/94, *Denkavit Int'l BV v. Bundesamt für Finanzen*, 1996 E.C.R. I-5063; Case C-170/05, *Denkavit Int'l BV*, 2006 E.C.R. I-11949.

47. The Commission wrote:

[w]hile the Commission regularly submits its observations to the ECJ in tax cases brought by individual taxpayers, it has itself brought only a limited number of infringement proceedings against Member States in the area of direct taxation [T]he Commission now intends to adopt a more pro-active strategy generally in the field of tax infringements and be more ready to initiate action where it believes that Community law is being broken. . . . There is a particular imperative in the direct tax field: the current approach of leaving the development of case law in the area of direct taxation to chance by simply reacting to cases taken by taxpayers to the ECJ is not a proper basis for progress towards agreed Community objectives.

Communication from the Commission to the Council, the European Parliament and the Economic and Social Committee, *Tax Policy in the European Union – Priorities for the Years Ahead*, at 22-23 COM (2001) 260 final.

48. Cf. Kathryn L. Moore, *State and Local Taxation: When Will Congress Intervene?* 23 *J. Legis.* 171 (1997) (using empirical evidence to confirm the prediction of political choice theory that Congress would be reluctant to interfere with state taxes); see also Shaviro, *supra* note 16, at 952-4 (arguing that Congress is unlikely to intervene to eliminate discriminatory taxes because vested interest in such taxes lies with business taxpayers who benefit from them and state and local governments that provide them,

If review of state taxes for discrimination should not be transferred to another government institution or abandoned altogether, special efforts should be made to rationalize the standards applied by courts to these cases. Some suggestions for limited improvements have been made in the literature, but comprehensive, predictable, and clear standards are needed in this important area of the law in both the United States and the European Union.

B. Double Taxation and Harmonization of the Tax Base

Harmonization of state taxes could solve the state tax discrimination question if under the harmonized system the states treated domestic and cross-border situations the same. This could involve adoption of a harmonized tax base coupled with a policy of dividing tax revenue among the states according to a uniform apportionment formula.⁴⁹

However, because harmonization would significantly reduce state tax autonomy, it is probably not politically feasible. Moreover, diversity among state tax systems is thought to have a variety of benefits that would be lost through harmonization. For example, state tax autonomy allows the state to respond quickly and flexibly to voter preferences, and the presence of competing tax jurisdictions imposes budgetary discipline on each state.⁵⁰ Despite these and other benefits of tax competition, diversity of tax laws in common markets produces significant compliance costs and locational distortions. For this reason, U.S. states have undertaken a variety of harmonization projects (with only moderate success), and policy-makers in the European Union have urged the adoption of comprehensive business tax harmonization in Europe.

1. Business Taxation

The state tax base for business income is substantially harmonized in the U.S. states.⁵¹ The reason for this is that almost all the states use the federal

whereas the harms of discriminatory taxes are diffuse, so that no particular group will champion their eradication).

49. Formulary apportionment is discussed at greater length, *infra* Part II.B.1.

50. For discussion of the advantages and disadvantages of inter-jurisdictional fiscal competition, with particular emphasis on the European Union, see Wallace E. Oates, *Fiscal Competition and the European Union: Contrasting Perspectives*, 31 *Regional Sci. & Urb. Econ.* 133 (2001).

51. The states distinguish between business income, which is generally taxed by formulary apportionment, and non-business income (including investment income), which is taxed according to source and residence rules. Business income is defined as "income arising from transactions and activity in the regular course of the taxpayer's trade or business," while all other income is non-business income. *Unif. Div. of Income for Tax Purposes Act* § 1(a), 7A U.L.A. 336 (1985) [hereinafter UDITPA].

tax base as the starting point for determining business income.⁵² Use of the federal income tax base reduces the risk that businesses will be subject to tax on different (and overlapping) tax bases in each state. This “piggy-backing” on the federal tax base is an example of voluntary tax base harmonization – no law or court decision requires states to use the federal tax base. They do it because it is easier: it reduces compliance expenses for enterprises doing business in the state, and it reduces the states’ enforcement costs because they can rely on federal enforcement mechanisms. The U.S. states retain control over revenue by setting their tax rates.⁵³ Because there is no federal income tax in Europe, the EU Member States do not have this option.

Despite reliance on the federal tax base, at least three features of state taxation introduce disharmonies in the United States. First, many states deviate from the federal tax base. Any deviations, unless also adopted by every other state, will result in disparities in the calculation of the same enterprise’s income by different states. Such disparities could result in income gaps or overlaps across the U.S. states. Gaps result in non-taxation of an enterprise’s income, while overlaps result in double or multiple taxation. Second, not all states use the same taxable unit.⁵⁴ While some states tax each legal entity separately, others allow various forms of consolidation, and still others see the “unitary” business as the appropriate taxable unit.⁵⁵ Such a unitary business may consist of more than one legal entity, and states have even historically sought to tax a portion of the income of foreign entities that were part of a unitary business active in the state.⁵⁶ Third, if an enterprise conducts business in more than one U.S. state, each state must determine how much of the enterprise’s overall income it will tax. An enterprise’s overall income is generally divided among the states using formulary apportionment. Apportionment formulas use the presence of the enterprise’s factors of production in each state – including

52. See Harley Duncan & LeAnn Luna, *Lending a Helping Hand: Two Governments Can Work Together*, 60 *Nat’l Tax J.* 663, 666 (“all but two corporate income tax states (Arkansas and Mississippi) and the District of Columbia use federal income as [the] starting point their taxable base”). For more detailed discussion of the methods of taxation of business income used by the U.S. states, see Hellerstein & Hellerstein, *supra* note 21, ¶ 7.02; Joann Martens-Weiner, *Company Tax Reform in the European Union* (2006).

53. Each U.S. state sets its tax rate independently of the other states and of the federal government. See references in *supra* note 52.

54. See Martens-Weiner, *supra* note 52, at 68, noting that the “taxable unit can generally be defined as a single entity, as a consolidated group, or as a unitary combined group.” Martens-Weiner further notes that although the U.S. states use different taxable units, the Canadian provinces tax on the basis of legal entity and do not allow consolidated or “combined” income reporting for related corporations. *Id.* at 69.

55. The “unitary” business is a concept that includes, but is not limited to, vertically integrated businesses. See generally *id.* at 68-72 (discussing tax avoidance opportunities created by the single entity approach).

56. See discussion of worldwide combined reporting, *infra* Part II.C.2.

property, payroll, and sales – to apportion taxable income to each state. However, the states do not all use the same formula, which means that the same income could be apportioned to more than one state (double taxation) or to no state (non-taxation).⁵⁷

State tax policy-makers are aware of these disharmonies, the locational distortions they create, and the administrative burdens they impose.⁵⁸ States have addressed some of these problems under the rubric of the Multistate Tax Compact, which established the Multistate Tax Commission (MTC), a body composed of representatives of the tax administrations of the member states. The MTC provides a forum through which states work to resolve tax problems. Specifically, efforts were made to introduce a consistent apportionment formula through the 1957 Uniform Division of Income for Tax Purposes Act (UDITPA). However, since only about half the states have adopted UDITPA, it has not brought uniformity to state apportionment formulas.⁵⁹

Disparities in state apportionment formulas have been challenged under the dormant Commerce Clause, but the Supreme Court has held that disparate apportionment formulas do not violate the Constitution. In the Court's view, the Constitution provides no mandate for state tax uniformity, and no guidelines as to what uniform standards might look like.⁶⁰ As a result, the Supreme Court will only strike down a state apportionment formula under very limited circumstances.⁶¹ An "internally inconsistent" formula, one that would inevitably result in double or multiple taxation if every state adopted it, violates the Commerce Clause, but formulas that result in "some [tax] overlap" without being internally inconsistent must be upheld because the Constitution prescribes no uniform state tax formula.⁶² The Supreme Court has expressly stated that Congress has the power under the Commerce Clause to impose a uniform

57. Compare the Canadian provinces, which use a common formula that allocates overall income to each province according to that province's portion of the company's total payroll and sales. See Martens-Weiner, *supra* note 52, at 34.

58. See Shaviro, *supra* note 16, at 920-9 for discussion and estimates of state tax compliance costs.

59. Hellerstein & McLure, *supra* note 2, at 90. See generally Bartley Hildreth, Matthew N. Murray & David L. Sjoquist, *Interstate Tax Uniformity and the Multistate Tax Commission*, 58 *Nat'l Tax J.* 575 (2005) (discussing the history and activities of the MTC and its success at achieving state tax harmonization).

60. See, e.g., *Moorman Mfg. Co. v. Bair*, 437 U.S. 267 (1978). See also Hellerstein & McLure, *supra* note 2, at 90 ("the US Supreme Court. . . has steadfastly refused to take an active role in prescribing specific state tax rules or in requiring uniformity").

61. Hellerstein & McLure, *supra* note 2, at 94 ("the US Supreme Court has accorded the states virtually unlimited discretion in determining the formulas they use to apportion income").

62. *Moorman Mfg. Co. v. Bair*, 437 U.S. 267 (1978).

apportionment formula on the states,⁶³ and many commentators have called for greater uniformity in state taxation, but Congress has so far declined to legislate.⁶⁴

At present, the EU Member States have no common system for taxing business profits. Every taxpayer reports its income to each country in which it is taxable according to the separate accounting method with arm's-length pricing. Under this method, which is the same method used by the United States and other countries to calculate taxable income in the international tax setting, taxpayers report their income to each EU Member State as determined under the disparate income tax laws of the 27 jurisdictions.⁶⁵ Gaps and overlaps in Member State tax bases and problems with determining arm's-length prices lead to non-taxation and double taxation of enterprises with business activities in more than one state. Additionally, the absence of a common tax base multiplies compliance costs for enterprises and states.

The proposed Common Consolidated Corporate Tax Base would provide a uniform EU-wide tax base, and importantly, a uniform method to apportion taxable income among the Member States in which an enterprise does business.⁶⁶ Each Member State would retain the autonomy to set its own tax rate. In the Article contained in this volume and in her book, Joann Martens Weiner advocates formulary apportionment for Europe because it is "better suited to avoid double taxation problems in the European Union than the arm's-

63. See *id.*, 437 U.S. at 280 ("It is clear that the legislative power granted to Congress by the Commerce Clause of the Constitution would amply justify the enactment of legislation requiring all States to adhere to uniform rules for the division of income. It is to that body, and not this Court, that the Constitution has committed such policy decisions.").

64. See, e.g., Shaviro, *supra* note 16 (arguing that Congress should harmonize the state tax bases). But see Moore, *supra* note 48 (giving reasons why Congress is unlikely to impose uniformity on the states).

65. For a concise explanation of separate accounting, see Martens-Weiner, *supra* note 52, at 3.

66. See Communication from the Commission to the Council, the European Parliament and the Economic and Social Committee, *Towards an Internal Market Without Tax Obstacles – A Strategy for Providing Companies with a Consolidated Corporate Tax Base for Their EU-Wide Activities*, COM (2001) 582 final (Oct. 23, 2001) [hereinafter 2001 Communication on Common Consolidated Corporate Tax Base]; Martens-Weiner, *supra* note 52. Using available data, Martens Weiner shows how selection of employment as the sole factor in the apportionment formula might apportion taxable income to the various Member States. See Martens-Weiner, *supra* note 52, at 37. She then shows how Unilever's 2001-2004 income might be apportioned under four different apportionment formulas, each involving some combination of property, payroll, and sales. *Id.* at 38-40. Martens Weiner also notes that the Member States may apportion income according to national macroeconomic factors, such as national income, rather than company-specific factors. *Id.* at 47.

length transfer pricing system.”⁶⁷ She also argues that while it may be politically infeasible for formulary apportionment to be the primary method for allocating taxable income of multinational enterprises to countries generally, the economic integration experienced in the European Union over the last decades has “largely made national EU Member State borders irrelevant,” and a move to formulary apportionment for Europe would reflect that economic reality.⁶⁸

Harmonization presents advantages, such as reducing compliance costs (including transfer pricing documentation) and the risk of double taxation within the Community. As the Member States continue to consider proposals for corporate tax base harmonization and formulary apportionment, they will continue to look to the experience of the United States and other federal tax systems. However, because they have the advantage of hindsight, the Member States can evaluate the advantages and disadvantages of those tax systems. Proponents of formulary apportionment for Europe hope to avoid some of the imperfections of the American system by insisting on uniformity of the tax base and the apportionment formula.⁶⁹ While U.S. states’ ability to deviate from each other on matters of tax policy gives them flexibility and may promote productive competition among the states, as noted above, tax disparities introduce significant inefficiencies.

In the absence of adoption of a common consolidated tax base and apportionment formula, the Member States will continue to tax corporate income according to separate accounting, with each state defining its own source rules. Cross-border loss offsetting among related companies will continue to pose a problem for enterprises operating in more than one Member State.⁷⁰ Under the current separate accounting system in Europe, double taxation

67. Martens-Weiner, *supra* note 52, at 9. See also Joann Martens Weiner, *Practical Aspects of Implementing Formulary Apportionment in the European Union*, 8 *Fl. Tax Rev.* 630 (2008) [hereinafter, Martens Weiner, *Formulary Apportionment*].

68. Martens Weiner, *Formulary Apportionment*, *supra* note 67, at 9.

69. See Martens-Weiner, *supra* note 52. Professors Hellerstein and McLure put their recommendation in strong terms when they wrote that “the EU should avoid the chaos that occurs because the [U.S.] states have excessive latitude (e.g. the lack of uniformity in, *inter alia*, apportionment formulas and definitions of groups).” See Hellerstein & McLure, *supra* note 2, at 98.

70. Martens Weiner noted in 2006 that although Austria, Denmark, and Italy allowed foreign subsidiaries’ losses to offset domestic profits, the remaining Member States that allowed loss offsetting limited it to related domestic companies. Martens-Weiner, *supra* note 52, at 19. To some extent, these rules must be altered to comply with the ECJ’s recent ruling in *Marks & Spencer* that a parent company’s state that allows domestic loss offsetting must allow the losses of a subsidiary established in another Member State to offset domestic income in cases where there is “no possibility” for the loss to be used in the subsidiary state. See C-446/03, *Marks & Spencer plc v. Halsey*, 2006 E.C.R. I-10,837. See also Michael Lang, *The Marks & Spencer Case – The Open Issues Following the ECJ’s Final Word*, 46 *Eur. Tax’n* 54, 67 (2006) (describing challenges to the implementation of the ECJ’s ruling).

of business income is relieved by credit or exemption, depending on the domestic laws of the relevant taxing states and their bilateral tax treaties. Although recent accession of new Member States created gaps in the EU tax treaty network, most intra-Community income is covered by tax treaties.⁷¹ However, where no double tax relief is required by a tax treaty or a Member State's domestic law, the ECJ has suggested that the EC Treaty imposes no additional obligation on EU Member States to relieve double taxation on intra-Community income.⁷²

At the same time that Europe looks to the United States as a model for a common consolidated tax base, the U.S. states should look more closely at the European proposals, which envision a uniform tax base and uniform apportionment method. If the European Union ultimately succeeds in establishing a uniform corporate tax system, despite the Member States' incredible tax diversity,⁷³ it might help convince the U.S. states that their tax differences are not intractable, and that base and formula harmonization may be feasible. Harmonization of the base and formula need not mean abandonment of tax competition or total surrender of Member State tax autonomy, since even under a harmonized tax base, states could control how much revenue they raise by retaining control over their tax rate. As noted previously, the European proposals for a common tax base with formulary apportionment envision that the Member States would independently set their tax rates.⁷⁴

Moreover, harmonization might produce other benefits by reducing the influence of taxpayer lobbyists. Business taxpayers favor state tax diversity for the arbitrage opportunities such diversity offers. Some commentators have argued that states' attempts to attract investment by offering tax holidays and other tax incentives itself constitutes unconstitutional tax discrimination that should be struck down by the Supreme Court under the dormant Commerce Clause,⁷⁵ while others have argued in favor of Congressional harmonization of

71. Georg Kofler & Ruth Mason, *Double Taxation: A European "Switch in Time?"* 14 *Colum. J. Eur. L.* 63 (2007) (describing the comprehensiveness of the intra-EU treaty network).

72. *Case C-513/04, Kerckhaert & Morres v. Staat*, 2006 E.C.R. I-10967 (holding that a Member State had no obligation to relieve double juridical tax on a cross-border portfolio dividend). For analysis and criticism of that case, see Mason & Kofler, *supra* note 71.

73. See Martens-Weiner, *supra* note 52, at 18 (noting that using a set of "ten central tax base elements," such as method of depreciation, the European Commission could not find any common approach among the Member States).

74. 2001 Communication on Common Consolidated Corporate Tax Base, *supra* note 66; Martens-Weiner, *supra* note 52, at 97. Cf. Shaviro, *supra* note 16 (making the same proposal for U.S. states).

75. See Enrich, *supra* note 31.

state taxes in order to promote greater tax neutrality in the allocation of investments across the U.S. states.⁷⁶

2. Individual Taxation

With respect to individual taxation, there are no serious plans in either jurisdiction to harmonize tax bases or to apply a uniform formula for apportioning taxable income among the states. Although the U.S. states use the federal tax base as the starting point for calculating an individual's taxable income, deviations abound.⁷⁷ Rather than apportioning individuals' income among the states, the U.S. states tax individuals' income according to source and residence rules. To prevent double taxation, residence states offer credits for taxes paid to fellow states on income sourced there.⁷⁸ However, because states have disparate source and residence rules, non-taxation and unrelieved double taxation may both occur. Additionally, some states, such as New York, have aggressive source rules, making double taxation of commuters from neighboring states more likely.⁷⁹ New York state courts have largely approved these aggressive source rules, and the Supreme Court has not agreed to hear appeals from the New York courts on this matter.⁸⁰

There is no federally defined tax base in the European Union. Member States tax individuals according to domestic source and residence rules, avoiding double taxation through credits and exemption, as provided under domestic law and in tax treaties.⁸¹ As mentioned previously, in an important case last year, the ECJ held that the EC Treaty does not require Member States to relieve double taxation on intra-Community income.⁸²

Interestingly, both the Supreme Court and the ECJ have considered the constitutional status of personal tax benefits. In the United States, it is unlawfully discriminatory for a host state to categorically deny nonresidents a variety of personal tax benefits granted to resident taxpayers, including personal exemptions and certain personal deductions.⁸³ Although a host state may deny

76. See Shaviro, *supra* note 16.

77. For more on U.S. state taxation, see Hellerstein & Hellerstein, *supra* note 21, ¶ 20.

78. See *id.*, at ¶ 20.10.

79. *Zelinsky v. Tax Appeals Tribunal*, 801 N.E.2d 840 (2003), cert. denied, 541 U.S. 1009 (2004) (upholding under the dormant Commerce Clause New York's rule considering personal services income to be sourced in New York if paid by a New York employer, even if the services are performed in another state, unless the services are performed outside New York for the convenience of the employer).

80. See, e.g., *id.*

81. In contrast, the U.S. states do not employ treaties to relieve double taxation.

82. Case C-513/04, *Kerckhaert & Morres v. Staat*, 2006 E.C.R. I-10967.

83. *Travis v. Yale & Towne Mfg. Co.*, 252 U.S. 60 (1920) (personal exemption).

nonresidents deductions for most personal expenses, particularly those that have a special nexus with another state, a host state may be required to allow nonresidents to deduct at least a pro rata share of personal expenses that lack nexus with another state.⁸⁴ The Court's rulings in this area have curious implications. For example, home mortgage interest has geographic nexus with the state wherein the home is located, so a host state would not have to allow a nonresident taxpayer a mortgage interest deduction for a home located in another state, even if it allows its own residents to deduct their mortgage interest. However, the Court has held that since alimony has no special nexus with any state, a host state that allows a resident to deduct alimony cannot categorically deny a nonresident pro rata alimony deductions.⁸⁵ As a result of the approach to personal expenses taken by the Supreme Court, U.S. states generally follow what in Europe has been called the "proportionality method;" they allow nonresidents to deduct personal expenses in proportion to their host state income.⁸⁶

In contrast, in the landmark *Schumacker* case, the ECJ placed the onus to account for personal expenses primarily on the taxpayer's home state by holding that a host state need only account for personal expenses if the home state is unable to do so, for example because the taxpayer has no taxable income in his or her home state.⁸⁷ This approach by the ECJ has led to the widespread adoption of so-called "*Schumacker*-rules," under which host states deny nonresidents all personal expenses, unless the nonresident's income in the host state exceeds a high statutory threshold.⁸⁸ When functioning optimally, both the U.S. proportionality method and the EU *Schumacker* method should result in entitlement to a full complement of personal tax benefits,⁸⁹ but it is interesting to see how differences in judicial approaches influenced legislative solutions to a tax problem common to the United States and the European Union.

In both common markets, if greater tax harmonization is desired, for example, to reduce compliance costs and locational distortions or to reduce the

84. See *Lunding v. New York Tax Appeals Tribunal*, 522 U.S. 287 (1998) (alimony).

85. *Id.*

86. *Hellerstein & Hellerstein*, supra note 21, ¶ 20.06[2][b]. "Proportionality" is a term used in the European tax context. See, e.g., Case C-385/00, *De Groot v. Staatssecretaris van Financiën*, 2002 E.C.R. I-11819 (holding that the Netherlands discriminated when it denied personal tax relief in proportion to residents' exempt foreign-source income).

87. Case C-279/93, *Finanzamt Köln-Altstadt v. Schumacker*, 1995 E.C.R. I-225.

88. The income threshold may be expressed as a percentage of the taxpayer's overall income (e.g., at least 90% of the taxpayer's overall income), or a dollar amount, or both. See, e.g., Case C-391/97, *Gschwind v. Finanzamt Aachen-Außenstadt*, 1997 E.C.R. I-5451.

89. For analysis of when these rules break down, see Ruth Mason, *Connecticut Yankees & the European Court* (2007) (work-in-progress on file with author).

likelihood of unrelieved double taxation, then harmonization must be accomplished through the central legislature or by cooperation among the states. The high courts of both common markets have made it clear that uniform rules for taxation and for relief of double taxation will not be imposed judicially.⁹⁰

C. Foreign Tax Relations

The United States has a true federal fiscal system. Long-standing debates in the United States concern whether the federal or state government is better suited to assess certain taxes and make certain expenditures.⁹¹ In contrast, due to the fact that the EU central government largely lacks tax powers and has a very small budget, vertical federalism debates in the European Union tend not to focus on taxing and spending issues. Instead, the principal vertical federalism issue for European taxation concerns tax relations with third countries. There is considerable debate about the scope of the European Union's "external tax competence," its ability to negotiate tax treaties and other tax agreements with third countries. Although it is clear that in the United States the power to enter into tax treaties with other countries belongs to the federal government, questions arise over the extent to which federal tax policy and foreign policy limit state tax powers.

1. European Tax Treaties: Competence and Multilateralism

At present, the Member States exclusively exercise the tax treaty power. The ECJ has repeatedly acknowledged the Member States' competence to negotiate tax treaties.⁹² Indeed, the EC Treaty expressly provides that Member States should enter into such treaties with each other with the goal of eliminating double taxation within the Community,⁹³ and the EC Treaty fails to provide expressly for the external tax competence of the European Union. Thus, the Member States have the authority to negotiate tax treaties both with each other and with third countries. The controversies in Europe concern whether the Community shares competence with the Member States to enter into tax agreements with third countries, and whether there are certain subject matters in which the Community is exclusively competent to enter tax agreements with

90. See *Moorman Mfg. Co. v. Bair*, 437 U.S. 267 (1978); Case C-513/04, *Kerckhaert & Morres v. Staat*, 2006 E.C.R. I-10967.

91. See David A. Super, *Rethinking Fiscal Federalism*, 118 *Harv. L. Rev.* 2544, 2564 (2005). Cf. Wallace E. Oates, *An Essay on Fiscal Federalism*, 37 *J. Econ. Lit.* 1120 (1999); Robert P. Inman & Daniel L. Rubinfeld, *Rethinking Federalism*, 11 *J. Econ. Perspectives* 43 (1997); Joel H. Swift, *Fiscal Federalism: Who Controls the States' Purse Strings?* 63 *Temp. L. Rev.* 251 (1990).

92. See Case C-336/96, *Gilly v. Directeur des Services Fiscaux du Bas-Rhin*, 1998 E.C.R. I-2793.

93. See EC Treaty, *supra* note 9, Art. 293.

third countries.⁹⁴ Space constraints do not permit comprehensive review of the arguments on these issues, and their resolution awaits judgment by the ECJ.

While the legal entitlement of EU Member States to enter into tax treaties is clear, it is constrained by Community law. The fundamental freedoms of the EC Treaty prohibit nationality discrimination, presumably even when that discrimination is accomplished through a tax treaty.⁹⁵ Commentators have observed that tax treaties currently in force in the EU may contain limitations on personal scope that have indirectly discriminatory effects. In particular, tax treaty limitations on benefits (LOB) clauses may restrict the application of tax treaties in such a way as to disproportionately exclude residents of EU Member States not party to the particular tax treaty. Indeed, that is their very purpose.⁹⁶ Despite this arguably discriminatory effect, the ECJ recently approved use of LOB clauses in tax treaties, at least when both contracting states are EU Member States.⁹⁷ Its decision suggests that the ECJ's attitude toward Member State tax treaties will be deferential.

94. See Richard Lyal, Note on the External Competence of the European Community in Tax Matters – The Example of the Agreement with Switzerland on the Taxation of Savings, in *The EU and Third Countries: Direct Taxation* (Michael Lang & Pasquale Pistone, eds., 2007). Lyal argued that although the Member States retain tax treaty competence, the Community was exclusively competent under the *ERTA* doctrine to enter into the taxation of savings agreement with Switzerland and to extend to Switzerland the benefits of the Parent-Subsidiary Directive and the Interest and Royalty Directive, although he noted the Council's disagreement with some of his conclusions. See also Pasquale Pistone, General Report, in *The EU and Third Countries: Direct Taxation 17*, 53-55 (Michael Lang & Pasquale Pistone, eds., 2007).

95. Case C-307/97, *Compagnie de Saint-Gobain, Zweigniederlassung Deutschland v. Finanzamt Aachen-Innenstadt*, 1999 E.C.R. I-6161 (holding that a Member State must grant to permanent establishments of EU companies benefits equivalent to those available under tax treaties to resident companies). But see Case C-376/03, *D. v. Inspecteur van de Belastingdienst*, 2005 E.C.R. I-5821 (finding no most-favored-nation requirement for tax treaties under EC law).

96. For discussion of the LOB issue under EC law, see Christiana HJI Panayi, *Double Taxation, Tax Treaties, Treaty Shopping and the European Community* (2007).

97. Case C-374/04, *Test Claimants v. Comm'rs of Inland Revenue (ACT Group Litigation)*, 2006 E.C.R. I-11673. There is no reason to think that the ECJ would show as much regard for the need of the United States (or any other third country) to prevent treaty shopping as it showed for the United Kingdom's need to prevent treaty shopping in *ACT Group Litigation*. In fact, prior non-tax cases suggest that the ECJ might take a jaundiced view of a bilateral treaty that countenanced discrimination against EU nationals by a non-Member State. For example, the *Open Skies* cases involved exclusion by the United States of EU nationals from benefits under bilateral air transportation treaties with Member States on the basis of nationality-linked criteria. In those cases, the ECJ held that by countenancing nationality discrimination by the United States, the EU treaty partners themselves committed nationality discrimination. For more on *Open Skies*, see Ruth Mason, *U.S. Tax Treaty Policy and the European Court of Justice*, 59 *Tax L. Rev.* 65 (2005) [hereinafter Mason, *Treaty Policy*].

Commentators have also considered whether a single multilateral tax treaty covering all of the Member States would be superior to the current network of hundreds of bilateral tax treaties.⁹⁸ Supporters of multilateralism argue that a single treaty could be more efficient, harder for treaty-shoppers to abuse, and it might help put to rest persistent questions about the compatibility of particular tax treaty provisions with EC law.⁹⁹ However, despite the potential advantages of multilateralism, there is a strong bias in favor of the extant (and extensive¹⁰⁰) bilateral tax treaty network.¹⁰¹ A less aggressive multilateral approach might involve the development of an official EU model bilateral tax treaty for use by the Member States when entering or renegotiating treaties. These proposals would not necessarily involve a transfer of treaty-making powers to the Community government, and could even be accomplished outside the EC infrastructure, either independently of any supranational organization, or under the auspices of the OECD. The ability to address shared tax challenges outside the formal Community legal structure might be important to the Member States, which have resisted coordinating their efforts through the Community for fear of relinquishing too much control over their tax systems.¹⁰²

Notice also that if the EU Member States adopt a common consolidated tax base, they will have to decide on what might be called its “external” components. For example, would consolidation stop at the European “water’s edge,” as proposed by the Commission?¹⁰³ Or would the apportionable tax base

98. For proposals regarding multilateral tax treaties, with special emphasis on the European Union and a draft text of a multilateral treaty, see *Multilateral Tax Treaties* (Michael Lang ed., 1997).

99. Mason, *Treaty Policy*, supra note 97; Michael Lang, *The Concept of a Multilateral Tax Treaty* 189, in *Multilateral Tax Treaties* (Michael Lang ed., 1997); Helmut Loukota, *Multilateral Tax Treaty Versus Bilateral Treaty Network* 83, in *Multilateral Tax Treaties* (Michael Lang ed., 1997).

100. The intra-EU treaty network alone comprises well over 300 bilateral tax treaties. See Mason & Kofler, supra note 71, at note 17.

101. See Loukota, supra note 99, at 94-96 (arguing, inter alia, that past failures of multilateralism and the divergence among national tax systems is cause for pessimism about the prospects of a multilateral tax treaty); see also Mason, *Treaty Policy*, supra note 97, at 121-130 (arguing that political realities in the European Union, including divergent interests among the Member States, make a multilateral treaty unlikely).

102. See Discussion Transcript, Symposium: International Tax Policy in the New Millennium: Panel IV: The Pursuit of National Tax Policies in a Globalized Environment (comments of Kees van Raad), 26 *Brook. J. Int'l L.* 1711, 1721 (2001) (arguing that the multilateral EU Arbitration Convention on transfer pricing was structured as a treaty, rather than a Council Directive in order to keep “the agreement outside of the reach of the EC court”).

103. The Committee of Experts recommended limiting EU consolidation to the European “water’s edge.” Martens-Weiner, supra note 52, at 31, n. 19.

comprise the worldwide unitary profits of any vertically integrated entity doing business in Europe?

2. U.S. State Taxation and the Foreign Commerce Clause

Because (1) the U.S. states cannot enter into treaties with foreign governments,¹⁰⁴ (2) the states generally have not entered into double tax compacts with each other,¹⁰⁵ and (3) bilateral tax treaties between the United States and other countries do not affect state taxation,¹⁰⁶ the tax treaty controversy has not arisen in the United States as it has in Europe. However, that does not mean that state tax policy lacks an international dimension.

Just as the Interstate Commerce Clause forbids states from discriminating against interstate commerce, the Supreme Court has held that the Foreign Commerce Clause forbids states from discriminating against foreign commerce. This means, for example, that a state may not include in a company's taxable income dividends from foreign, but not U.S., subsidiaries.¹⁰⁷ The most significant controversies concerning the U.S. states and foreign tax relations have concerned some states' inclusion of foreign-source income in the state tax base.

Until the 1990s, California and several other U.S. states imposed "worldwide combined reporting" requirements on companies engaged in business within their territory. Worldwide combined reporting had the effect of including the foreign income of companies affiliated with the taxpayer in the apportionable base, even if those affiliates were themselves established outside the United States. All that was required in order to include the profits of the related foreign affiliate in the apportionable tax base was that the in-state company and the foreign affiliate were engaged in a single "unitary business," a concept variously defined in state law.¹⁰⁸ Several taxpayers challenged

104. U.S. Const. Art. I, § 10, cl. 3.

105. Although the Constitution's Compact Clause provides that "[n]o State shall, without the consent of Congress. . . enter into any Agreement or Compact with another State, or with a foreign power," the Supreme Court has interpreted the provision to require Congressional consent only when the compact would result in an "increase of political power in the States, which may encroach upon or interfere with the just supremacy of the United States." *Virginia v. Tennessee*, 148 U.S. 503, 519 (1893); see also *United States Steel Corp. v. Multistate Tax Comm'n*, 434 U.S. 452 (1978) (rejecting Compact Clause challenge to the Multistate Tax Compact).

106. The federal government has the authority to enter into tax treaties that constrain state taxes, but it has not generally exercised that authority. See Peter H. Blessing & Carol Dunahoo, *Analysis of United States Income Tax Treaties* ¶ 1.03[1][b] (2006); see also *infra* note 111 and accompanying text for discussion of the attempt to narrow the exercise of state tax powers in the U.S.-U.K. tax treaty.

107. *Kraft General Foods, Inc. v. Iowa Dep't of Revenue*, 505 U.S. 71 (1992).

108. See, e.g., *Container Corp. of Am. v. Franchise Tax Bd.*, 463 U.S. 159, 165-68 (1983). See also *Hellerstein & Hellerstein*, *supra* note 21, ¶ 8.09.

worldwide combined reporting under the Foreign Commerce Clause, arguing that the practice created a risk of multiple taxation and prevented the federal government from “speaking with one voice in regulating foreign trade.”¹⁰⁹

However, the Supreme Court repeatedly upheld the application of worldwide combined reporting requirements to both U.S. and foreign multinationals.¹¹⁰ Despite the Court’s blessing, the persistence of mandatory worldwide combined reporting met with so much protest from U.S. trading partners that federal legislation limiting state taxation to the U.S. “water’s edge” was proposed, but not adopted. The United Kingdom even convinced U.S. tax treaty negotiators to include a provision in a proposed bilateral tax treaty that would have prevented the application of worldwide combined reporting requirements to U.K. companies doing business in the United States. However, due to extensive lobbying by the states, the Senate refused to ratify the tax treaty unless the provision was read out of it.¹¹¹

It is a testament to the strength of state tax sovereignty that none of the efforts initiated at the federal government level to impose water’s edge as a legal limitation on state taxation succeeded: (1) the Supreme Court refused to hold worldwide combined reporting was an unconstitutional tax on extraterritorial income, (2) Congress was unwilling to preempt state taxes through legislation, even though it has ample power to do so under the Foreign Commerce Clause,¹¹²

109. The Foreign Commerce Clause imposes these two additional requirements on states when taxing foreign commerce. See *Japan Line, Ltd. v. County of Los Angeles*, 441 U.S. 434, 452 (1979) (holding that California could not, consistently with the Commerce Clause, levy a fairly apportioned property tax on Japanese containers that were subject to an unapportioned property tax in Japan because California’s tax would (1) inevitably result in international multiple taxation and (2) interfere with federal uniformity in regulating foreign trade).

110. *Barclays Bank PLC v. Franchise Tax Board*, 512 U.S. 298 (1994) (upholding application to foreign company); *Container Corp. of Am. v. Franchise Tax Bd.*, 463 U.S. 159 (1983) (upholding application to U.S. company). The Supreme Court recognized that worldwide combined reporting could lead to double taxation, but it was not convinced that separate accounting would not also lead to double taxation, since both systems by necessity have arbitrary aspects. See *Container* at 190-191. The Court also held that worldwide combined reporting did not threaten the federal government’s foreign tax policy, especially since tax treaties do not generally affect state tax powers. *Id.* at 197; see *Barclays* at 321-322, 326. For criticism of the Court’s ruling in *Barclays* because it robbed the “one voice” doctrine of “any real significance” beyond the doctrine of federal preemption, see Hellerstein & Hellerstein, *supra* note 21, ¶ 8.16[3][b].

111. The Senate entered a reservation to the proposed treaty stating that the relevant article would not be interpreted to apply to state and local taxation. See Blessing & Dunahoo, *supra* note 106, ¶ 1.03[1][b].

112. See Hellerstein & McLure, *supra* note 2, at 90 (“Congress has rarely enacted statutes to limit state taxing power, and the statutes that have been enacted have generally been quite narrow in scope.”).

and (3) the Senate would not ratify a tax treaty limiting the states' ability to tax. Ultimately, however, federal, international, and private sector pressure proved successful, and the states themselves passed legislation limiting the application of worldwide combined reporting.¹¹³

D. Subsidies, Tax Incentives, and Interstate Competition

All the issues discussed so far raise the issue of tax competition. States discriminate against nonresidents in order to provide their own residents with a competitive advantage. At the same time, states define their tax base and rates with interstate competition in mind: they want to retain domestic investment and attract investment by outsiders. Favorable business tax rules and a comprehensive program for relief of double taxation may help to stimulate such investment. In addition to non-tax considerations, individuals and businesses consider the particular mix of tax liability and public services offered by a particular state when making locational decisions.¹¹⁴ State tax autonomy facilitates competition among states, but some commentators claim that unbridled competition may result in a destructive "race to the bottom," jeopardizing states' ability to raise sufficient revenue to fund their public policies. Such competition may be especially fierce in a common market in which people, business, and capital are free from legal constraints on cross-border movement.¹¹⁵

113. See generally Hellerstein & Hellerstein, *supra* note 21, ¶ 8.17; see also Moore, *supra* note 48, at 198-200 (describing states' adoption of "water's edge" limitations in response to threatened federal legislation and pressure from business); Martens-Weiner, *supra* note 52, at 13, n. 23 (describing how in its opinion in *Barclay's Bank*, the "Supreme Court noted that 'a battalion of foreign governments' had 'marched to Barclay's aid,' deploring worldwide combined reporting in diplomatic notes, amicus briefs, and even retaliatory legislation").

114. Charles M. Tiebout, *A Pure Theory of Local Expenditures*, 64 *J. Pol. Econ.* 416 (1956) (showing that under certain assumptions, residents will sort themselves into local jurisdictions by preference for level of taxes and government services). Empirical research supports the notion that in the international context, patterns of investment are responsive to taxes. See, e.g., James R. Hines, Jr., *Altered States: Taxes and the Location of Foreign Direct Investment in America*, 86 *American Econ. Rev.* 1076 (1996) (finding that differences in state tax rates affected the location of foreign direct investment within the United States, particularly where foreign investors could not credit U.S. state taxes against their home country tax liability).

115. See Enrich, *supra* note 31 (arguing that the U.S. states are engaged in a destructive competition to provide business tax incentives); Communication from the Commission to the Council and the European Parliament: *A Package to Combat Harmful Tax Competition in the European Union*, COM (1997) 564 final (May 11, 1997) (discussing tax competition among the EU Member States). But see Oates, *supra* note 50, at 137 (characterizing the studies on inter-jurisdictional tax competition as finding that such competition results in suboptimal equilibria, rather than a "race to the

Subsidies and tax incentives highlight the advantages and disadvantages of tax competition. In the United States, the states are permitted to use their tax systems to compete for business, investment, and residents, as long as they do not discriminate against interstate commerce.¹¹⁶ But whether tax incentives constitute unconstitutional discrimination is unclear.¹¹⁷ The U.S. Supreme Court in *West Lynn Creamery* held that states could not “conjoin” a nondiscriminatory tax assessed on both in-state and out-of-state interests with a subsidy granted only to in-state interests if the effect of the combination of the tax and subsidy resulted in harsher taxation of out-of-state than in-state interests.¹¹⁸ However,

bottom” or a “downward spiral in public sector activities”); cf. Clayton P. Gillette, *Business Incentives, Interstate Competition, and the Commerce Clause*, 82 Minn. L. Rev. 447 (1997) (arguing more generally that regulatory competition between the states may be constructive).

116. Quoting the Supreme Court, the Sixth Circuit in *Cuno* noted that: [T]he Commerce Clause “does not prevent the States from structuring their tax systems to encourage the growth and development of intrastate commerce and industry,” nor does it prevent a state from “compet[ing] with other States for a share of interstate commerce” so long as “no State [] discriminatorily tax[es] the products manufactured or the business operations performed in any other State.”

Cuno v. DaimlerChrysler, Inc., 386 F.3d 738, 742-43 (6th Cir. 2004), vacated in part, 126 S. Ct. 1854 (2006) (quoting *Boston Stock Exch. v. State Tax Comm’n*, 429 U.S. 318, 336-37 (1977)). For discussion of *Cuno*, see *infra* notes 117 to 120 and accompanying text.

117. For the argument that business tax incentives violate the dormant Commerce Clause, see Enrich, *supra* note 31. But cf. Zelinsky, *supra* note 28 (arguing that because the Court cannot meaningfully distinguish subsidies from discriminatory taxes, it should abandon its dormant Commerce Clause review of state taxes altogether).

118. *West Lynn Creamery, Inc. v. Healy*, 512 U.S. 186 (1994) (striking down a tax on both in-state and out-of-state dealers selling milk into Massachusetts when the proceeds of the tax were distributed only to Massachusetts dairy farmers). The Court stated that:

Nondiscriminatory measures, like the evenhanded tax at issue here, are generally upheld, in spite of any adverse effects on interstate commerce, in part because ‘[t]he existence of major in-state interests adversely affected. . . is a powerful safeguard against legislative abuse. . . .’ However, when a nondiscriminatory tax is coupled with a subsidy to one of the groups hurt by the tax, a State’s political processes can no longer be relied upon to prevent legislative abuse, because one of the in-state interests which would otherwise lobby against the tax has been mollified by the subsidy.

Id. at 200 (citations omitted) (quoting *Minnesota v. Clover Leaf Creamery Co.*, 449 U.S. 456, 473, n. 17 (1981)).

in dicta, the Court gave its approval of subsidies funded from general revenues.¹¹⁹

The Sixth Circuit in *Cuno* recently held an Ohio investment tax credit to violate the Commerce Clause because it discriminated against interstate commerce.¹²⁰ The Sixth Circuit concluded that Ohio's tax incentive was unconstitutional because it provided a tax advantage when new property was put into service within Ohio, but not when property was put into service in other states.¹²¹ Ohio imposed more burdensome taxation on companies doing business in Ohio that decided to expand into other states than those that decided to expand into Ohio, a practice the Court found coercive.¹²² However, the Circuit Court distinguished the investment tax credit from direct subsidies, suggesting, as has the Supreme Court, that direct subsidies do not violate the Commerce Clause.¹²³

Although the Supreme Court granted certiorari in *Cuno*, it did not reach the merits of the constitutional challenge to state tax incentives because it held that the taxpayers did not have standing to challenge the incentives in the first place. Still, several similar cases challenging state tax incentives under the dormant Commerce Clause are pending in lower courts, so the Supreme Court

119. *West Lynn* at 199 n. 15 (“We have never squarely confronted the constitutionality of subsidies, and we need not do so now. We have, however, noted that ‘[d]irect subsidization of domestic industry does not ordinarily run afoul’ of the negative Commerce Clause.”) (quoting *New Energy Co. of Ind. v. Limbach*, 486 U.S. 269, 278 (1988))

120. *Cuno v. DaimlerChrysler, Inc.*, 386 F.3d 738 (6th Cir. 2004), vacated in part, 547 U.S. 332 (2006) (invalidating under the Commerce Clause a tax credit extended by Ohio against its franchise tax to DaimlerChrysler in exchange for the company's location of assets in Toledo). In reaction to the Sixth Circuit's decision in *Cuno*, federal legislation was introduced to expressly authorize states to offer such tax subsidies, which would address any Commerce Clause infirmity inherent in them. See Economic Development Act of 2005 (S. 1066). Notably, the Sixth Circuit in *Cuno* held that property tax abatements granted by Ohio and Toledo to DaimlerChrysler did not run afoul of the Commerce Clause. See *Cuno*, 386 F.3d at 746-48.

121. *Cuno*, 386 F.3d at 743-46.

122. *Id.* at 746. In analyzing the plaintiffs' argument that state tax incentives are unconstitutional if they are coercive, the Circuit Court referred to Walter Hellerstein & Dan T. Coenen, *Commerce Clause Restraints on State Business Development Incentives*, 81 *Cornell L. Rev.* 789, 806-09 (1996).

123. “Although the defendants liken the investment tax credit to a direct subsidy, which would no doubt have the same economic effect, the [Supreme] Court has intimated that attempts to create location incentives through the state's power to tax are to be treated differently from direct subsidies despite their similarity in terms of end-result economic impact.” *Cuno* at 746.

may answer this important question sometime soon. How it should answer the question is a matter of considerable controversy in the United States.¹²⁴

In the European Union, the status of subsidies and tax incentives is somewhat clearer: they are prohibited as “state aids,” unless the Commission approves them.¹²⁵ Compared with the United States, less energy has been invested in Europe in the question of whether tax incentives and subsidies are sufficiently different to warrant different constitutional treatment. Both direct subsidies and subsidies granted through the tax system are clearly covered by the prohibition on state aids, which governs aid granted in “any form whatsoever.”¹²⁶ Indeed, there have been many successful challenges by the Commission of tax provisions under the prohibition on state aids.¹²⁷ But the role of the Commission as gatekeeper of Member State subsidies and tax incentives could be criticized on at least two grounds. First, the Commission has not adequately defined what constitutes a state aid,¹²⁸ and second, the Commission may be insufficiently zealous in challenging state aids. Still, while some subsidies and tax incentives may go unchallenged by the Commission, and others have been expressly approved by the Commission, in principle, state aids,

124. See references in *supra* note 115; see also Dan T. Coenen, *Business Subsidies and the Dormant Commerce Clause*, 107 *Yale L. J.* 965 (1998); Dan T. Coenen & Walter Hellerstein, *Suspect Linkage: The Interplay of State Taxing and Spending Measures in the Application of Constitutional Antidiscrimination Rules*, 95 *Mich. L. Rev.* 2167 (1997) (offering guidelines for when the Supreme Court should strike down state subsidies).

125. See EC Treaty, *supra* note 9, Art. 87 (“... aid granted by a Member State ... in any form whatsoever which distorts or threatens to distort competition ... shall, in so far as it affects trade between Member States, be incompatible with the common market”); see *id.* Arts. 88-89 (requiring Member States to inform the Commission of plans to implement or alter state aids and requiring Commission approval to do so); see also Hanno E. Kube, *Competence Conflicts and Solutions: National Tax Exemptions and Transnational Controls*, 9 *Colum. J. Eur. L.* 79 (2003); Raymond H.C. Luja, *Assessment and Recovery of Tax Incentives in the EC and WTO: A View on State Aids, Trade Subsidies and Direct Taxation* (2003); Wolfgang Schön, *Taxation and State Aid Law in the European Union*, 36 *Common Mkt. L. Rev.* 911 (1999).

126. EC Treaty, *supra* note 9, Art. 87

127. See, e.g., *Case C-156/98, Germany v. Comm’n*, 2000 *E.C.R.* I-6857 (successfully challenging tax relief offered by Germany in the former East German regions because it did not comply with the exceptions to the ban on state aid for former East Germany).

128. See Kube, *supra* note 125, at 99. Identifying a subsidy granted through the tax code requires determination of the normal baseline of taxation, a notoriously difficult problem that arises in several contexts, including tax expenditure budgets and trade treaties. For suggestions about how to define subsidies for trade treaty purposes, see Paul R. McDaniel, *Trade Agreements and Income Taxation: Interactions, Conflicts and Resolutions*, 57 *Tax L. Rev.* 275, 275-90 (2004) (suggesting reference to domestic tax expenditure budgets).

including those granted through the tax system, violate EC law if they distort competition among the Member States.

Another important limitation on state tax competition in the European Union, for which there is no analog in the United States, is the Code of Conduct for Business Taxation, under which the Member States undertook to cease and roll back certain "harmful" tax practices, identified as such by the European Commission.¹²⁹ Harmful tax measures include offering outside investors lower tax rates than those generally available to residents of the host country, granting tax benefits to nonresidents who have no real economic activity in the host state, departures from the OECD transfer pricing guidelines, and lack of transparency in the tax system. The Code of Conduct is not legally binding on the Member States, but rather represents a political commitment among the states to refrain from engaging in harmful tax competition.

III. CONCLUSION

George Washington's particular vision of a United States of Europe similar to the United States of America that would legislate for all the nationalities of Europe has not come to pass. However, while it is important to be mindful of the vast differences in both government structure and fiscal systems in the United States and the European Union, a tour of some of the tax problems common to both jurisdictions suggests that tax policy-makers in each jurisdiction may benefit from examining approaches taken in the other. In particular, the nature of the debates in Europe and the United States over the future of state taxation are similar in that they acknowledge a tension between the benefits of greater tax harmonization, including efficiency, simplicity and reducing opportunities for tax avoidance, and the benefits of state tax autonomy, including flexibility, responsiveness, experimentation, and fiscal discipline.

129. See Communication from the Commission to the Council and the European Parliament: A Package to Combat Harmful Tax Competition in the European Union, COM (1997) 564 final (May 11, 1997). See also Conclusions of the ECOFIN Council Meeting, 1998 O.J. (C 2) 1; Commission Notice on the Application of State Aid Rules to Measures Relating to Direct Business Taxation, 1998 O.J. (C 384) 3.