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Neutrality and Territoriality – Competing or Converging Concepts in European Tax Law?

This article is based on the Klaus Vogel Lecture delivered on 24 October 2014 at the Vienna University of Economics and Business. It criticizes the increasing recognition of territorial taxing rights in the jurisprudence of the ECJ and pleads strongly both for a unilateral discrimination test and the revival of the concept of coherence.

1. Introduction

It is well known that there is a deep-seated conflict between the concept of an ever-closer Internal Market within the European Union, on the one hand, and the ongoing sovereignty of the Member States in the area of direct taxation, on the other. The wide-reaching judicature of the Court of Justice of the European Union (ECJ or the "Court") on the interaction between the fundamental freedoms and domestic tax legislation,[1] which currently covers more than two hundred decisions,[2] disregarding cases on indirect taxation or State aid, is a clear indication not only of the political and practical relevance of this tension, but also of the lack of clear guidance provided for the governments of the Member States and national courts. Many commentators have expressed their dissatisfaction with the state of affairs as far as tax law is concerned.[3]

The most relevant question, however, appears to be as yet unanswered. Is the meandering path adopted by the ECJ in direct tax matters a sign of missing analytical or conceptual capacity, thereby revealing a court that is clearly not specialized in tax as being overwhelmed by intricate technical detail and torn by diverging views on political integration? Or is this jurisprudence a fine example for the diplomatic skills of the ECJ in navigating through the delicate issues of multi-level governance?[4] Or has the ECJ set itself on a mission impossible, in trying to reconcile institutional claims that, from a fundamental standpoint, cannot be fulfilled simultaneously as supremacy must be granted to one or the other?[5]

This article is not intended to provide a final answer. However, it is intended to further clarify the underlying themes by differentiating between the different strands within the ECJ's judicature, identifying arguments and assessing results, thereby highlighting both reliable statements and contradictory considerations. There are two possible ways to undertake this exercise. An "inductive" approach would attempt to analyse the existing corpus of decisions one by one, thereby assembling a picture of the case law and forming a judgement on the coherence of the overall view. A "deductive" approach would start from the principles underlying the Internal Market and the relationship between EU law and domestic law in a generalized fashion, thereby using these principles as a benchmark for the evaluation of the individual judgements delivered by the ECJ. Those who consider the current scope and effect of the fundamental freedoms to be purely judge-made and who assign to academic writing the role of a tour guide to the ECJ's reasoning would argue for the first approach. This is not the starting point of this analysis. We must recognize that the fundamental freedoms play a functional role in the overall context of the Internal Market as provided by the various EU Treaties. And we have to accept that the EU Treaties have established a division of competences between the EU Institutions and the Member States.

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1. For a comprehensive presentation by one of the ECJ's most eminent representatives, *see* K. Lenaerts, *Die gemeinschaftsrechtliche Umrahmung der direkten Besteuerung* in *Verhandlungen des 66. Deutschen Juristentages 2006*, vol. II/1, p. Q9 (C.H. Beck 2006); K Lenaerts & L. Bernardeau, *L'encadrement communautaire de la fiscalité directe*, *Cahiers de droit européen*, p. 19 (2007); and B. Terra & P.J. Wattel, *European Tax Law* 6th ed., chs. 3 & 15-22 (Kluwer 2012).
2. For ECJ cases in the area of, or of particular interest for, direct taxation, *see* http://ec.europa.eu/taxation_customs/common/infringements/case_law/index_en.htm. *See also* ECJ Case Law IBFD, available at www.ibfd.org and *Materials on International, TP & EU Tax Law* vol. 3, p. 4047 et seq. (K. van Raad ed., Intl. Tax Ctr. Leiden U. 2014/15).
3. F.A. Garcia Prats, *Is it Possible to Set a Coherent System of Rules on Direct Taxation under EC Law Requirements*, in *A Vision of Taxes within and outside European Borders: Festschrift in Honor of Prof. Dr. Frans Vanistendael* p. 429 (L. Hinnekens & P. Hinnekens eds., Kluwer 2008); M. J. Graetz & A.C. Warren, *Income Tax Discrimination and the Political and Economic Integration of Europe*, 115 Yale Law Journal, p. 1186 (2006), *Dividend Taxation in Europe: When the ECJ makes Tax Policy*, 44 Common Mkt L. Rev., p. 1577 (2007) and *Income Tax Discrimination: Still Stuck in the Labyrinth of Impossibility*, 121 Yale Law Journal, p. 1118 (2012); S. Kingston, *The Boundaries of Sovereignty: The ECJ's Controversial Role Applying Internal Market Law to Direct Tax Measures*, Cambridge Y.B. Eur. Leg. Stud. p. 287 (2007); M. Lang, *Direct Taxation: Is the ECJ Heading in a New Direction?*, 46 Eur. Taxn. 9 (2006), Journals IBFD and *Recent Case Law of the ECJ in Direct Taxation: Trends, Tensions, and Contradictions,* 18 EC Tax Rev. 3, p. 98 (2009); J. Malherbe et al., *Direct Taxation in the Case-Law of the European Court of Justice* (Larcier 2008); R. Mason, *Flunking the ECJ's Tax Discrimination Test*, 46 Columbia J. Transnatl. Law, p. 72 (2007); R. Mason & M.S. Knoll, *What is Tax Discrimination?*, 121 Yale L. J, p. 1014 (2012) and *A Brief Sur-Reply to Professors Graetz and Warren*, 123 Yale L. J. Online, p. 1 (2013); W. Schön, *Taxing Multinationals in Europe,* in *Hoyt Skattet: Festkrift til Frederik Zimmer* p. 471 (B. Banoun, O. Gjems-Onstad & A.A. Skaar eds., Universitetsforlaget 2013); P.J. Wattel, *Red Herrings in Direct Tax Cases before the ECJ,* 31 Leg. Issues in Econ. Integration, p. 81 (2004) and *Commentary: Judicial Restraint and Three Trends in the ECJ's Direct Tax Case Law*, 62 Tax L. Rev., p. 205 (2008) p.205; and D. Weber, *In Search of a (New) Equilibrium between Tax Sovereignty and the Freedom of Movement within the EC*, 34 Intertax 12, p. 585 (2006).
4. D. Gutmann, *Some Theoretical Thoughts on Judicial Power and Tax Law, with a Particular Focus on the ECJ,* in Hinnekens & Hinnekens eds., *supra* n. 3, at p. 485.
5. Graetz & Warren (2006), *supra* n. 3, at p. 1206 et seq. and J. Monsenego, *Taxation of Foreign Business Income within the Europen Internal Market* (IBFD 2012) Online Books IBFD.

The ECJ's judicature in tax matters is, after all, an interpretation of the written law of the EU Treaties and one should, therefore, start with the central provisions and policy goals of the Treaty on European Union (TEU)[6] and the Treaty on the Functioning of the European Union (TFEU).[7]

In order to provide a heuristic framework for the analysis, this article is arranged with a view on the following two major principles of taxation, i.e.: (1) that of neutrality; and (2) that of territoriality. Both principles have time-honoured reputations with regard to international taxation. At the same time, they represent different challenges to EU law. While the concept of neutrality pleads for equal treatment of taxable events, irrespective of where they are located, the concept of territoriality refers to "the need to take into account the limits on the Member States' powers of taxation".[8] Klaus Vogel, to whose memory this article is dedicated, envisaged a tax system for Europe where both principles were meant to be implemented in a harmonious fashion.[9] We shall see whether or not these two concepts are likely to converge or bound to compete under EU law.

2. Neutrality and the Internal Market

2.1. Neutrality between domestic and cross-border activities

The concept of neutrality is an economic concept that is related to the decision-making of economic actors.[10] A tax as such, or a particular tax provision, can be neutral if it does not exercise any influence on the decision of a person to act in a specific manner. Any such distortion of private decision-making could result in welfare losses, i.e. "deadweight losses". Income taxation creates an inefficient bonus in respect of leisure over labour and net wealth taxation involves an inefficient bonus in respect of consumption over saving. It is nearly self-evident that in a world where there are taxes the objective of full neutrality cannot be realized.[11] But the question remains to what extent and in which fields of legislation it is possible and necessary to reduce inefficiencies at least in part?

The Internal Market should, according to article 26 of the TFEU, "comprise an area without internal frontiers in which the free movement of goods, persons, services and capital is ensured". This basic definition is rooted in the same efficiency-oriented thinking as the concept of tax neutrality.[12] According to article 120 second sentence of the TFEU, "the Member States shall act in accordance with the principle of an open market economy with free competition, favouring an efficient allocation of resources". The underlying efficiency objective requires a legal framework, which ensures that decisions affecting the allocation of goods, persons, services and capital are not distorted by domestic law-making, including national tax legislation. The objective of the Internal Market to ensure the "free movement" of these factors not only prevents the Member States from erecting outright legal barriers to cross-border traffic, but it also prohibits the Member States from taking any action that, in the language of the ECJ,[13] is likely to "deter", "discourage" or "dissuade" economic actors from moving freely within the confines of the European Union, even if the obstacle is "of limited scope or minor importance".[14] These quotes emphasize the material grounding of the efficiency objective of undistorted decision-making in the legal DNA of the Internal Market.[15] Neutrality, we can, therefore, conclude, is a concept of EU law.

Yet neutralities come in many forms and disguises as economic actors must make decisions in many dimensions. So far, neither the taxpayer's choice of whether to work or to be idle nor his preference of whether to save or to consume is the object of the Treaty provisions on free movement of resources. With regard to other neutralities, this is less clear. It is, in particular, disputed as to whether the fundamental freedoms protect the free choice between debt and equity finance[16] or whether they argue for a neutral

6. Treaty on European Union and Treaty Establishing the European Community (TEU) (consolidated version), OJ C321 (2006), EU Law, IBFD.
7. Treaty on the Functioning of the European Union (TFEU) (consolidated version), OJ C83 (2010), EU Law, IBFD.
8. DE: ECJ, 15 Oct. 2009, Case C-35/08, *Grundstücksgemeinschaft Busley and Cibrian Fernandez v. Finanzamt Stuttgart-Körperschaften* para. 30, ECJ Case Law IBFD.
9. K. Vogel, *Which Method Should the European Community Adopt for the Avoidance of Double Taxation?*, 56 Bull. Intl. Taxn. 1 (2002), Journals IBFD.
10. A. Auerbach, *The Theory of Excess Burden and Optimal Taxation* in: *Handbook of Public Economics*, vol. 1 ch. 2, p. 61 et seq. (A. Auerbach & M. Feldstein eds., Elsevier1985) and *The Deadweight Loss from "Non-Neutral" Capital Income Taxation*, 40 J. Pub. Econ., p. 1 (1989).
11. D. Weisbach, *The Use of Neutralities in International Tax Policy*, U. of Chicago, Coase-Sandor Inst. L. & Econ. Working Paper No. 697 (2014).
12. W. Schön, *Tax Competition in Europe: The Legal Perspective,* 9 EC Tax Rev. 2, p. 97 et seq. (2000) and E.C.C.M. Kemmeren, *Double Tax Conventions on Income and Capital and the EU: Past, Present and Future*, 21 EC Tax Rev. 3, p. 158 et seq. (2012).
13. NL: ECJ, 6 June 2000, Case C-35/98, *Staatssecretaris van Financiën v. B.G.M. Verkooijen* para. 34, ECJ Case Law IBFD; BE: ECJ, 21 Jan. 2010, Case C-311/08, *Société de Gestion Industrielle SA (SGI) v. Belgian State*, para. 50, ECJ Case Law IBFD; DK: ECJ, 17 July 2014, Case C-48/13, *Nordea Bank Danmark A/S v. Skatteministeriet* para. 22, ECJ Case Law IBFD; SE: ECJ, 26 June 2003, Case C-422/01, *Försäkringsaktiebolaget Skandia (publ) and Ola Ramstedt v. Riksskatteverket* para. 28, ECJ Case Law IBFD; BE: ECJ, 1 July 2010, Case C-233/09, *G.A. Dijkman and M.A. Dijkman-Lavaleije v. Belgische Staat* paras. 25 & 31, ECJ Case Law IBFD; PL: ECJ, 10 Apr. 2014, Case C-190/12, *Emerging Markets Series of DFA Investment Trust Company v. Dyrektor Izby Skarbowej w Bydgoszczy* para. 39, ECJ Case Law IBFD; FR: ECJ, 11 Mar. 2004, Case C-9/02, *Hughes de Lasteyrie du Saillant v. Ministère de l'Économie, des Finances et de l'Industrie* para. 45, ECJ Case Law IBFD; BE: ECJ, 23 Jan. 2014, Case C-296/12, *European Commission v. Kingdom of Belgium* para. 31, ECJ Case Law IBFD; AT: ECJ, 15 July 2004, Case C-315/02, *Anneliese Lenz v. Finanzlandesdirektion für Tirol* para. 20, ECJ Case Law IBFD; NL: ECJ, 18 Oct. 2012, Case C-498/10, *X NV v. Staatssecretaris van Financiën* paras. 22 & 30, ECJ Case Law IBFD; PT: ECJ, 26 Oct. 2006, Case C-345/05, *Commission of the European Communities v. Portuguese Republic* para. 20, ECJ Case Law IBFD; ES: ECJ, 25 Apr. 2013, Case C-64/11, *European Commission v. Kingdom of Spain* para. 28, ECJ Case Law IBFD; BE: ECJ, 4 June 2009, Joined Cases C-439/07 and C-499/07, *Belgische Staat v. KBC Bank NV and Beleggen, Risicokapitaal, Beheer NV v. Belgische Staat* para. 64, ECJ Case Law IBFD; and BE: ECJ, 12 Dec. 2013, Case C-303/12, *Guido Imfeld, Nathalie Garcet v. État belge* paras. 52 & 53, ECJ Case Law IBFD.
14. *De Lasteyrie du Saillant* (C-9/02), at para. 43 and LU: ECJ, 22 Dec. 2010, Case C-287/10, *Tankreederei I SA v. Directeur de l'administration des contributions directes* para. 17 , ECJ Case Law IBFD.
15. A. Cordewener, *The Prohibitions of Discrimination and Restriction within the Framework of the Fully Integrated Internal Market*, in *EU Freedoms and Taxation* p. 4 et seq. (F. Vanistendael ed., IBFD 2003); M. Gammie, *The Compatibility of National Tax Principles with the Single Market*, in Vanistendael ed, *supra*, at p. 110 et seq.; and F. Vanistendael, *The Compatibility of the Basic Economic Freedoms with the Sovereign National Tax Systems of the Member States*, 12 EC Tax Rev. 3, p. 141 et seq. (2003).
16. R. Obser, *Gesellschafter-Fremdfinanzierung im europäischen Konzern* p. 47 et seq. (IDW-Verlag 2005).

tax system with regard to the legal form of a business.[17] But one thing is agreed. The fundamental freedoms prohibit any domestic legislation that separates domestic economic activities and cross-border economic activities.[18]

The prohibition of internal customs duties on import and export and all charges with equivalent effect under article 30 of the TFEU is the most prominent expression of this principle within the EU Treaties.[19] This provision is complemented by article 110 of the TFEU, which confirms the power to tax resting with the Member States, as long as they do not discriminate against imported or exported goods. Going beyond these explicit prohibitions,[20] the ECJ has made clear over the last 30 years that any legislation in the area of direct taxation that results in the unequal treatment of cross-border activities as opposed to purely domestic activities is forbidden, unless the Member State in question can demonstrate a valid justification for this legislation.

In order to achieve this, the EJC has employed the following two lines of reasoning. First, it has expanded the concept of discrimination from "overt" to "covert" discrimination, thereby compelling host Member States to grant equal treatment to all sorts of inbound flows of assets and activities.[21] Second, the ECJ has applied the concept of restriction to include any tax burden imposed by home Member States on resident taxpayers specifically on outbound assets or activities.[22] One can, therefore, read the history of direct tax cases under EU law as an evolution from a limited concept linked to discrimination of persons on the basis of their nationality[23] to a simultaneously simple and far-reaching prohibition on cross-border tax obstacles to economic entities and transactions in general.[24]

2.2. Cross-border neutrality with regard to domestic legislation

When it comes to the interplay between the requirement for cross-border neutrality and domestic tax sovereignty, the outcome appears to be quite straightforward. The Member States are free to legislate as they see fit, as long as they do not provide for disadvantageous treatment of international situations compared to domestic situations.[25] The Member States are also free to decide which type of tax they want, what the tax base is and how the tax rates are set. But they must ensure that inbound flows and outbound flows of economic value are not discriminated against. This rigid rule is safeguarded by two statements of the ECJ regarding possible justifications. The Member States cannot, as a matter of principle, complain regarding the "loss of revenue" as a legitimate matter of public interest.[26] Budgetary considerations do not justify

17. FR: ECJ, 28 Jan. 1986, Case 270/83, *European Commission v. French Republic (Avoir Fiscal)* para. 22, ECJ Case Law IBFD; DE: ECJ, 21 Sept. 1999, Case C-307/97, *Compagnie de Saint-Gobain, Zweigniederlassung Deutschland v. Finanzamt Aachen-Innenstadt* para. 53, ECJ Case Law IBFD; DE: ECJ, 23 Feb. 2006, Case C-253/03, *CLT-UFA SA v. Finanzamt Köln-West* para. 14, ECJ Case Law IBFD; *KBC* (C-439/07 and C-499/07), at paras. 75-81; NL: ECJ, 25 Feb. 2010, Case C-337/08, *X Holding v. Staatssecretaris van Financiën* paras. 35-41, ECJ Case Law IBFD; and UK: ECJ, 6 Sept. 2012, Case C-18/11, *The Commissioners for Her Majesty's Revenue & Customs v. Philips Electronics UK Ltd* para. 14, ECJ Case Law IBFD. *See also* Malherbe et al. *supra* n. 3, at p. 70 et seq.; C. HJI Panayi, *European Union Corporate Tax Law* p. 198 et seq. (Cambridge 2013); W. Schön, *The Free Choice between the Right to Establish a Branch and to Set-up a Subsidiary* p. 339 (EBOR 2001); and P.J. Wattel, *Corporate Tax Jurisdiction in the EU with respect to Branches and Subsidiaries; Dislocation Distinguished from Discrimination and Disparity; A Plea for Territoriality,* 12 EC Tax Rev. 4, p. 194 (2003).
18. *Avoir Fiscal* (270/83), at para. 24; DE: ECJ, 14 Feb. 1995, Case C-279/93, *Finanzamt Köln-Altstadt v. Roland Schumacker* paras. 20-24, ECJ Case Law IBFD; NL: ECJ, 27 June 1996, Case C-107/94, *P.H. Asscher v. Staatssecretaris van Financiën* para. 36, ECJ Case Law IBFD; and *Commission v. Portugal* (C-345/05), at para. 15.
19. A. Dashwood et al., *European Union Law* 6th ed., p. 391 et seq. (Hart 2011).
20. The close analogy between the effect of the Internal Market on indirect taxes and direct taxes is stressed by Vanistendael, *supra* n. 15, at p. 136 et seq.
21. LU: ECJ, 8 May 1990, Case C-175/88, *Klaus Biehl v. Administration des Contributions du Grand-Duché de Luxembourg* paras. 13 & 14, ECJ Case Law IBFD; UK: ECJ, 13 July 1993, Case C-330/91, *The Queen v. Inland Revenue Commissioners, ex parte Commerzbank AG* paras. 14 & 15, ECJ Case Law IBFD; *Schumacker* (C-279/93), at paras. 26-28; *Asscher* (C-107/97), at paras. 38 & 39; DE: ECJ, 12 Dec. 2002, Case C-324/00, *Lankhorst-Hohorst GmbH v. Finanzamt Steinfurt* paras. 27-29, ECJ Case Law IBFD; GR: ECJ, 20 Jan. 2011, Case C-155/09, *Commission of the European Communities v. Hellenic Republic* paras. 44-46, ECJ Case Law IBFD; HU: ECJ, 5 Feb. 2014, Case C-385/12, *Hervis Sport- és Divatkereskedelmi Kft. v. Nemzeti Adó- és Vámhivatal Közép-dunántúli Regionális Adó Főigazgatósága* paras. 30-39, ECJ Case Law IBFD; UK: ECJ, 1 Apr. 2014, Case C-80/12, *Felixstowe Dock and Railway and Others v. the Commissioners for Her Majesty's Revenue & Customs* paras. 25 & 26, ECJ Case Law IBFD; and NL: ECJ, 12 June 2014, Joined Cases C-39/13, C-40/13 and C-41/13, *Inspecteur van de Belastingdienst/Noord/kantoor Groningen v. SCA Group Holding BV* paras.24-26, ECJ Case Law IBFD. *See also* Cordewener *supra* n. 15, at p. 7 et seq.; F. Vanistendael, *Taxation and Non-Discrimination, A Reconsideration of Withholding Taxes in the OECD*, 2 World Tax J. 2, sec. 2.1. (2010), Journals IBFD; S. van Thiel, *The Direct Income Tax Case Law of the European Court of Justice: Past Trends and Future Developments,* 62 Tax L. Rev., p. 159 et seq. (2008); and Weber *supra* n. 3, at p. 587 et seq.
22. *Nordea* (C-48/13), at para. 18; UK: ECJ, 16 July 1998, Case C-264/96, *Imperial Chemical Industries (ICI) v. Kenneth Hall Colmer* para. 21, ECJ Case Law IBFD; SE: ECJ, 18 Nov. 1999, Case C-200/98, *X AB and Y AB v. Riksskatteverket* para. 26 , ECJ Case Law IBFD; BE: ECJ, 14 Dec. 2000, Case C-141/99, *Algemene Maatschappij voor Investering en Dienstverlening NV (AMID) v. Belgische Staat* para. 21, ECJ Case Law IBFD; BE: ECJ, 4 July 2013, Case C-350/11, *Argenta Spaarbank NV v. Belgische Staat* para. 20, ECJ Case Law IBFD; UK: ECJ, 27 Sept. 1988, Case 81/87, *The Queen v. H.M. Treasury and Commissioners of Inland Revenue, ex parte Daily Mail and General Trust plc.* para. 16, ECJ Case Law IBFD; NL: ECJ, 13 Apr. 2000, Case C-251/98, *C. Baars v. Inspecteur der Belastingen Particulieren/Ondernemingen Gorinchem* para. 28, ECJ Case Law IBFD; DE: ECJ, 23 Feb. 2006, Case C-471/04, *Keller Holding v. Finanzamt Offenbach am Main-land* para. 30, ECJ Case Law IBFD; UK: ECJ, 12 Sept. 2006, Case C-196/04, *Cadbury Schweppes plc,Cadbury Schweppes Overseas Ltd v. Commissioners of Inland Revenue* para. 42, ECJ Case Law IBFD; DE: ECJ, 29 Mar. 2007, Case C-347/04, *Rewe Zentralfinanz eG v. Finanzamt Köln-Mitte* para. 26, ECJ Case Law IBFD; PL: ECJ, 19 Nov. 2009, Case C-314/08, *Krzysztof Filipiak v. Dyrektor Izby Skarbowej w Poznaniu* para. 60, ECJ Case Law IBFD; and *Société de Gestion Industrielle* (C-311/08), at para. 39.
23. For an example of the narrow construction, *see* DE: ECJ, 26 Jan. 1993, Case C-112/91, *Hans Werner v. Finanzamt Aachen-Innenstadt* paras. 12-16, ECJ Case Law IBFD.
24. Lenaerts, *supra* n. 1, at p. Q 34 et seq.
25. ES: ECJ, 8 Dec. 2011, Case C-157/10, *Banco Bilbao Vizcaya Argentaria SA v. Administración General del Estado* paras. 28 & 29, ECJ Case Law IBFD and BE: ECJ, 16 July 2009, Case C-128/08, *Jacques Damseaux v. État Belge* para. 24 et seq., ECJ Case Law IBFD. *See also* Mason *supra* n. 3, at p. 92 et seq.; Terra & Wattel, *supra* n. 1, at p. 58 et seq.; S. van Thiel, *Why the European Court of Justice should Interpret Directly Applicable Community Law as a Right to Most-Favoured Nation Treatment and a Prohibition of Double Taxation*, in *The Influence of European Law on Direct Taxation: Recent and Future Developments* p. 88 et seq. (D. Weber ed., Kluwer 2007); F. Vanistendael, *General Report on the Fundamental Freedoms and Tax Sovereignty* in Vanistendael ed., *supra* n. 15, at p. 205 et seq.; and Weber, *supra* n. 3, at p. 586.
26. *Emerging Markets* (C-190/12), at para. 102; *Saint-Gobain* (C-307/97), at paras. 49 & 50; SE: ECJ, 21 Nov. 2002, Case C-436/00, *X and Y v. Riksskatteverket* para. 50, ECJ Case Law IBFD; *Lankhorst-Hohorst* (C-324/00), *supra* n. 21, at para. 36; NL: ECJ, 18 Sept. 2003, Case C-168/01, *Bosal Holding BV v. Staatssecretaris van Financiën* para. 42, ECJ Case Law IBFD; LU: ECJ, 14 Nov. 1995, Case C-484/93, *Peter Svensson and Lena Gustavsson v. Ministre du Logement et de l'Urbanisme* para. 18, ECJ Case Law IBFD; UK: ECJ, 8 Mar. 2001, Joined Cases C-397/98 and 410/98, *Metallgesellschaft Ltd*

unequal treatment, as the tax sovereignty of the Member States grants them the freedom to introduce new taxes, increase tax rates or broaden the tax base to generate additional public revenue in a non-discriminatory fashion.[27] The Member States also cannot use unequal treatment as a means of protecting the domestic economy against foreign intruders. This is a clear indication of the relationship between tax discrimination and undistorted competition in the Internal Market.[28]

2.3. Double taxation and international neutrality

2.3.1. Double taxation as an obstacle to the Internal Market

When we focus on one Member State and its legislation, it is fairly easy to assess whether or not its tax laws comply with the requirements of cross-border neutrality. This is the well-known "unilateral view" in matters of non-discrimination and non-restriction.[29] Things become difficult when two or more Member States apply their tax provisions to a single economic event.[30] This challenge is not so much based in the fact that the Member States exercise their tax sovereignty in different ways, levying different taxes, defining different tax bases or setting different tax rates. Even if all tax systems within the European Union were the same, covering the same set of economic events under identical provisions as to tax base and tax rate, setting the same rules for limited tax liability and unlimited tax liability, the result might be an obstacle to cross-border flows.[31] This obstacle is double taxation. In contrast to all other fields of legislation, ranging from corporate law to patent law or property law, with regard to taxation the sheer harmonization of substantive rules does not suffice to remove all of the obstacles to cross-border traffic.[32] The mere fact that two Member States apply the same rules in parallel to raise revenue for their respective budgets can result in a double burden on international economic activities that then drives an enormous wedge between purely internal and cross-border situations.[33]

2.3.2. Double taxation and the allocation of taxing powers between Member States

It is well known that the ECJ has, so far, declined to declare mere double taxation to be an infringement of the fundamental freedoms of EU taxpayers.[34] From the legal point of view, this is not based in the language of the provisions of the EU Treaties on the fundamental freedoms, which address individual Member States and their domestic legislation. The ECJ is willing to declare invalid bilateral tax treaties[35] between several Member States or even secondary legislation at the EU level, such as EU Directives,[36] both of which cannot be allocated to single Member States.

The best argument which the ECJ has advanced so far to justify its reluctance to deal with cases of double taxation lies in the concession that there are simply no criteria available at the level of the EU Treaties which would help the ECJ to grant priority to the tax claims of one of the Member States involved, thereby forcing the other Member State to either exempt the taxable event or grant a credit for foreign tax.[37] It is not self-evident whether the

and Others, Hoechst AG and Hoechst (UK) Ltd v. Commissioners of Inland Revenue and HM Attorney General para. 49, ECJ Case Law IBFD; NL: ECJ, 12 Dec. 2002, Case C-385/00, *F.W.L. de Groot v. Staatssecretaris van Financiën* para. 103, ECJ Case Law IBFD; *Skandia-Ramstedt* (C-422/01), at para. 53; *De Lasteyrie du Saillant* (C-9/02), at para. 60; *Lenz* (C-315/02), at para. 40; FI: ECJ, 7 Sept. 2004, Case C-319/02, *Petri Manninen* para. 49, ECJ Case Law IBFD; UK: ECJ, 13 Dec. 2005, Case C-446/03, *Marks & Spencer plc v. Halsey (Her Majesty's Inspector of Taxes)* para. 44, ECJ Case Law IBFD; DE: ECJ, 6 Mar. 2007, Case C-292/04, *Wienand Meilicke, Heidi Christa Weyde and Marina Stöffler v. Finanzamt Bonn-Innenstadt* para. 30, ECJ Case Law IBFD; and *Tankreederei I* (C-287/10), at para. 27. *See also* Lenaerts, *supra* n. 1, at p. Q 70; Mason, *supra* n. 3, at p. 85; and L. Hinnekens, *Basis and Scope of Public Interest Justification of National Tax Measures Infringing Fundamental Treaty Freedoms,* in Vanistendael ed., *supra* n. 15, at p. 75 et seq. and p. 88 et seq.

27. DE: ECJ, 11 Sept. 2007, Case C-76/05, *Herbert Schwarz und Marga Gootjes-Schwarz v. Finanzamt Bergisch Gladbach* para. 98, ECJ Case Law IBFD.
28. *Verkooijen* (C-35/98), at para. 48; FR: ECJ, 10 Mar. 2005, Case C-39/04, *Laboratoires Fournier SA v. Direction des vérifications nationales et internationals* para. 23, ECJ Case Law IBFD; DE: ECJ, 17 Jan, 2008, Case C-152/05, *Commission of the European Communities v. Federal Republic of Germany* paras. 27 & 28; *Busley/Cibrian* (C-35/08), at paras. 31 & 32; and *Commission v. Greece* (C-155/09), at paras. 52-55. For a slightly more generous view, *see Tankreederei I* (C-287/10), at paras. 30-33.
29. Malherbe et al., *supra* n. 3, at p. 135 et seq. and Schön, *supra* n. 12, at p. 97 et seq.
30. *See* the contributions to A. Rust, *Double Taxation within the Europen Union* (Kluwer 2011) and D. Gutmann, *How to Avoid Double Taxation in the European Union?*, in *Allocating Taxing Powers within the European Union* p. 63 et seq. (I. Richelle, W. Schön, E. Traversa eds., Springer 2013).
31. I. Roxan, *Assuring Real Freedom of Movement in EU Direct Taxation*, 63 Modern L. Rev., p. 833 et seq. (2000).
32. This is also the reason why the concept of "mutual recognition" does not help when it comes to the collection of the tax. As stated in J. Snell, *Non-Discriminatory Tax Obstacles in Community Law*, 56 Intl. & Comp. L. Q. 2, p. 365 (2007): "[t]he collection of revenue by one State in no way protects the revenue interest of another". This does not exclude to apply mutual recognition when it comes to specific features of the tax base, i.e. legal personality, corporate groups, nationality and residence, etc. *See also* E. Reimer, *Taxation – An Area without Mutual Recognition?,* in Richelle, Schön & Traversa, *supra* n. 30, at p. 197.
33. It is true that double taxation is compatible with the neutrality principle if the Member States involved do not distinguish at all between residents and non-residents in their domestic laws, for example, by applying worldwide income taxation to both residents and non-residents. *See* Mason, *supra* n. 3, at p. 86. Double taxation would be simply omnipresent but not discriminatory. Yet this option is barred by international customary law. The only remaining option for having a fully neutral international tax system is full tax harmonization, including not only an identical definition of the tax base and tax rates, but also a strict delineation of taxing powers between the involved jurisdiction.
34. DE: ECJ, 12 Feb. 2009, Case C-67/08, *Margarete Block v. Finanzamt Kaufbeuren* paras. 28-31, ECJ Case Law IBFD; HU: ECJ, 15 Apr. 2010, Case C-96/08, *CIBA Speciality Chemicals Central and Eastern Europe Szolgáltátó, Tanácsadó és Keresdedelmi Kft. v. Adó- és Pénzügyi Ellenőrzési Hivatal Hatósági Főosztály* para. 25, ECJ Case Law IBFD; DE: ECJ, 11 Sept. 2014, Case C-47/12, *Kronos International Inc. v. Finanzamt Leverkusen* para. 68, ECJ Case Law IBFD; *Emerging Markets* (C-190/12), at para. 103; BE: ECJ, 19 Sept. 2012, Case C-540/11, *Daniel Levy and Carine Sebbag v. État Belge* para. 18, ECJ Case Law IBFD; BE: ECJ, 14 Nov. 2006, Case C-513/04, *Mark Kerckhaert and Bernadette Morres v. Belgische Staat* paras. 18 & 19, ECJ Case Law IBFD; DE: ECJ, 6 Dec. 2007, Case C-298/05, *Columbus Container Services B.V.B.A. & Co. v. Finanzamt Bielefeld-Innenstadt* paras. 41-46, ECJ Case Law IBFD; and NL: ECJ, 20 May 2008, Case C-194/06, *Staatssecretaris van Financiën v. Orange European Smallcap Fund NV* paras. 38-49, ECJ Case Law IBFD.
35. *De Groot* (C-385/00), at para. 94; *Saint-Gobain* (C-307/97); and NL: ECJ, 16 Oct. 2008, Case C-527/06, *R.H.H. Renneberg v. Staatssecretaris van Financiën* para. 51, ECJ Case Law IBFD.
36. AT: ECJ, 26 Oct. 2010, Case C-97/09, *Ingrid Schmelz v. Finanzamt Waldviertel* para. 33 et seq., ECJ Case Law IBFD.
37. DE: ECJ, 23 Jan. 2014, Case C-164/12, *DMC Beteiligungsgesellschaft mbH v. Finanzamt Hamburg-Mitte* para. 47, ECJ Case Law IBFD; *Levy and Sebbag* (C-540/11), at para. 19; DE: ECJ, 28 Feb. 2013, Case C-168/11, *Dr Manfred Beker and Christa Beker v. Finanzamt Heilbronn* para. 32, ECJ Case Law IBFD; *Banco Bilbao* (C-157/10), at paras. 30, 31, 38 & 39; *Damseaux* (C-128/08), at para. 30; FI: ECJ, 18 June 2009, Case C-303/07, *Aber-*

salaries of an employee should be taxed according to his nationality, his residence or his workplace. It is not self-evident whether interest is taxed in the Member State where the payments are received by the creditor or in the Member State where the payments are effected by the debtor. Royalty income from the licensing of intellectual property (IP) rights can be allocated to the following four different jurisdictions: (1) the Member State where the IP right has been developed; (2) the Member State where it is used to produce goods; (3) the Member State where the goods are sold; and (4) the Member State where the owner of the IP right resides. Neither international customary law nor EU Treaty law contains an overarching framework on the allocation of taxing rights.[38] The same is true for indirect taxation, where both the origin principle and the destination principle cohabitate awkwardly within the framework of the VAT Directive (2006/112).[39]

This is the official line taken by the ECJ since *Gilly* (Case C-336/96)[40] was decided and defended against widespread criticism.[41] But when we take a preliminary look at the jurisprudence of the ECJ, in general, it is fair to say that the Court has implicitly or explicitly deviated from this agnostic stance in the following two ways:

(1) In some judgements, the ECJ refers to the OECD Model[42] and its provisions as a sort of "gold standard" for international tax allocation.[43] This view has been supported in the literature to provide a starting point for elimination of double taxation within the framework of the fundamental freedoms.[44] But, in the current situation of international tax policy, we find fundamental rules of the OECD Model under attack, both with regard to the conflict between industrialized and emerging or developing countries and with regard to the ongoing debate on base erosion and profit shifting.[45] Major concepts, such as "permanent establishment" and the "arm's length" standard are being eroded by modern business organization. Last but not least, there is no statutory link between a model treaty drafted by a limited group of countries and hard-wired EU Treaty law. If a domestic tax rule or a provision enshrined in a tax treaty follows the OECD Model, such reference can be regarded as a limited evidence for plausibility or consensus, but it cannot pre-empt the judgement on its compatibility with the Internal Market. It is far from being accepted as "customary international law".[46]

(2) In other judgements, and more so recently, the ECJ has implicitly emphasized a certain priority of the source Member State to tax income.[47] This has become evident in the line of cases regarding cross-border relief for corporate tax, in several judgements dealing with attempts to counter cross-border tax avoidance and in the never-ending story of cross-border loss compensation. I will go deeper into these cases later in this article (*see* section 4.2.). But it should be noted at this point that the ECJ perceives the principle of territoriality more and more to be a principle granting first choice to the jurisdiction where, in the language of the Court, "income is derived".[48] Similar considerations of the ECJ point to a subsidiary obligation of the residence Member State to take into account deductions that cannot be used in the source Member State. This approach conflicts with the over-

deen Property Fininvest Alpha Oy v. Uudenmaan verovirasto and Helsingin kaupunki para. 25, ECJ Case Law IBFD; *X and Y* (C-436/00), at para. 53; SE: ECJ, 19 Jan. 2006, Case C-265/04, *Margaretha Bouanich v. Skatteverket* para. 49, ECJ Case Law IBFD; *Kerckhaert Morres* (C-513/04), at para. 22; *Columbus Container* (C-298/05), at para. 45; *Orange European Smallcap Fund* (C-194/06), at para. 32; and DE: ECJ, 20 Oct. 2011, Case C-284/09, *Commission of the European Communities v. Federal Republic of Germany* paras. 44 & 45, ECJ Case Law IBFD. *See also* K. Lenaerts, *The Court of Justice and EU Law* in: *Taxation of Intercompany Dividends under Tax Treaties and EU Law* p. 7 (G. Maisto ed., IBFD 2012), Online Books IBFD; Terra & Wattel, *supra* n. 1, at p. 24 et seq.; Wattel (2008), *supra* n. 3, at p. 215 et seq.; and A. Rust, *How European Law Could Solve Double Taxation*, in *Double Taxation within the European Union* p. 136 et seq. & p. 139 et seq. (A. Rust ed., Kluwer 2011).

38. W. Schön, *International Tax Coordination for a Second-Best World (Part I)*, 1 World Tax J. 1, sec. 2. (2009), Journals IBFD. For a different view, *see* Kemmeren, *supra* n. 12, at p. 159: "principle of origin".
39. Council Directive 2006/112/EC of 28 November 2006 on the common system of value added tax, EU Law IBFD.
40. FR: ECJ, 12 May 1998, Case C-336/96, *Gilly v. Directeur des services fiscaux du Bas-Rhin* paras. 23-35, ECJ Case Law IBFD.
41. G. Kofler, *Double Taxation and European Law: Analysis of the Jurisprudence*, in Rust ed., *supra* n. 37, at p. 97; G. Kofler & R. Mason, *Double Taxation: A European Switch-In Time*, 14 Columbia J. Eur. L. 14, p. 63 (2007); Malherbe et al., *supra* n. 3, at p. 130 et seq.; and S. van Thiel, *Avoiding a Double Burden within the European Union: Comments on Profs. Kofler and Rust's Analysis*, in Rust ed., *supra* n. 37, at p. 167 et seq. and *supra* n. 21, at p. 164 et seq. One proposal in the literature is to declare double taxation to constitute an infringement and to establish "joint and several liability" of the Member States involved to allow them to sort out among themselves by negotiation who pays (Kofler *supra* and van Thiel *supra*). The problem with this proposal is that double taxation does not only result from missing tax credits or tax exemptions, but also from a large amount of disparities when it comes to income measurement, the timing of accrual, loss offset provisions, etc. An outright ban on double taxation would, therefore, result in enormous pressure on tax law harmonization, which has no basis and no benchmarks in EU law. A further proposal is to seek "consistency", i.e. to require Member States to grant relief for foreign tax insofar as they claim a prior taxing right in the reverse situation (Kofler & Mason, *supra*, at p. 91 et seq.). A. Rust *supra* n. 37, at p. 153 et seq. simply goes beyond what the Member States are willing to surrender under existing tax treaties (P. Wattel, *Passing the Buck Around: Who is Responsible for Double Taxation? – Comments on Profs. Kofler and Rust's Analysis*, in Rust ed., *supra* n. 37, at p. 163 et seq.). To put it differently, the Member States can use residence and source for the same item of income on a cumulative basis for taxing rights and they are not required to give up one to employ the other.
42. Most recently, *OECD Model Tax Convention on Income and on Capital* (15 July 2014), Models IBFD.
43. *Asscher* (Case C-107/94), at para. 47; DE: ECJ, 12 June 2003, Case C-234/01, *Arnoud Gerritse v. Finanzamt Neukölln-Nord*, para. 45, ECJ Case Law IBFD; NL: ECJ, 23 Feb. 2006, Case C-513/03, *Heirs of M.E.A. van Hilten-van der Heijden v. Inspecteur van de Belastingdienst/Particulieren/Ondernemingen buitenland te Heerlen* para. 48, ECJ Case Law IBFD; NL: ECJ, 7 Sept. 2006, Case C-470/04, *N. v. Inspecteur van de Belastingdienst Oost/kantoor Almelo* paras. 44-46, ECJ Case Law IBFD; and DE: ECJ, 15 May 2008, Case C-414/06, *Lidl Belgium GmbH & Co. KG v. Finanzamt Heilbronn* para. 22, ECJ Case Law IBFD.
44. Kemmeren *supra* n. 12, at p. 169 et seq.; Kofler & Mason *supra* n. 41, at p. 81; and Gutmann, *supra* n. 30, at p. 70 et seq.
45. H. Ault, *Some Reflections on the OECD and the Sources of International Tax Principles,* 70 Tax Notes Intl. p. 1195 (17 June 2013) and L.A. Sheppard, Twilight of the International Consensus: How Multinationals Squandered Their Tax Privileges, 44 Washington U. J. L. & Policy, p. 61 (2014).
46. J. Wouters & M. Vidal, *An International Lawyer's Perspective on the ECJ's Case Law Concerning the OECD Model Tax Convention and its Commentaries,* in Hinnekens & Hinnekens eds., *supra* n. 3, at p. 999 et seq.
47. Rust, *supra* n. 37, at p. 130 et seq. and Wattel (2004), *supra* n. 3, at p. 87 et seq.
48. UK: ECJ, 12 Dec. 2006, Case C-374/04, *Test Claimants in Class IV of the ACT Group Litigation v. Commissioners of Inland Revenue* paras. 57 & 59, ECJ Case Law IBFD.

arching statement that EU law does not prescribe the allocation of taxing powers between the Member States and does not resolve the problem of double taxation mechanically. Consequently, the ECJ should remain true to its position. If there is no explicit allocation of taxing rights under EU law, this should not be put into question by vague and unfounded considerations as to the pecking order between source and residence taxation. We will revisit this point when we discuss the principle of territoriality (*see* section 4.2.).

2.3.3. *Cross-border neutrality, disparities and the leeway for tax competition*

As double taxation has not been abolished under EU law in a self-executing manner, the question remains as to whether the voluntary removal of double taxation by the Member States as such, for example, either by virtue of a multilateral instrument, an EU directive or a network of bilateral tax treaties, would finally ensure cross-border neutrality. The answer is no. This is because unilateral and bilateral provisions that are intended to mitigate double taxation only ensure that the tax burden on a given economic activity, asset or transaction is not higher than it would be in one of the states involved. This is provided for by either the credit method or the exemption method. But as long as the Member States can exercise their tax sovereignty freely with regard to tax type, tax base and tax rate, cross-border activities are likely to face tax burdens, which are different from those levied on purely domestic activities. This is very clear when the exemption method is applied to cross-border income, as this gives prevalence to the tax system of the source Member State. But this is also clear when the credit method is applied, as this method does not grant relief for source taxation, which goes beyond the tax rate in the home Member State.

From a legal perspective, the ECJ has rightly emphasized that the existence of "disparities" between legal systems of the Member States is not, in itself, an object of criticism.[49] According to the EU Treaties, the concept of international tax neutrality is not the single goal of EU tax law. Rather, this must be balanced with other objectives of the European Union. One of these political objectives is the preservation of fiscal sovereignty of the Member States. This prerogative of the Member States in tax matters is not an atavistic remainder of ancient nation states withering away in the progress of an "ever closer" Union and a more and more expanding Internal Market. It is well established within the framework of the EU Treaties, most prominently, as Advocate General Kokott highlighted in a recent Opinion, in the unanimity requirement for tax harmonization set out in articles 113, 114(2) and 115 of the TFEU.[50] The ECJ, therefore, never claimed that EU law is aimed at full cross-border tax neutrality within the Internal Market.[51] The fundamental freedoms only require the individual Member States to shape their own tax laws compliant to the demands of neutrality. Last but not least, the existence of "taxation as such" is not put into question. Member States do not have to defend their budgetary needs as fiscal "restrictions" on individual freedoms.[52]

Most prominently, the lingering tax sovereignty of the Member States can contribute to overall welfare and efficiency within the Internal Market in its own way, as it maintains tax competition between the Member States. It is a well-researched result of international public finance that both full harmonization and full tax competition can have both a positive and negative effect on overall efficiency.[53] In particular, the pressure of tax competition on governments to provide a well-balanced package of public services, redistribution and tax allocation feeds nicely into the Internal Market in creating not only an area free of legal constraints, but also a competitive environment.[54] The ECJ has supported this view in several judgements where it was held that the existence of low tax rates in other Member States does not justify, as such, defensive measures on the part of the Member States against cross-border outflow of assets and activities.[55]

2.3.4. *The influence of the legislation of other Member States on tax neutrality*

2.3.4.1. *Per-Member State view or overall view?*

What is the outcome on tax neutrality? The Internal Market does not require tax neutrality in all possible ways. Rather, it focuses on the abolition of cross-border discrimination by individual Member States. This results in the equal treatment of international and internal economic events from the unilateral perspective of the jurisdictions involved, i.e. the home Member State and the host Member State.[56] It neither requires the abolition of double taxation

49. *Block* (C-67/08), at paras. 31 & 35 and *CIBA* (C-96/08), at para. 28. *See also* S. Douma, *The Three D's of Direct Tax Jurisdiction: Disparity, Discrimination and Double Taxation*, 46 Eur. Taxn. 11, sec. 3. (2006), Journals IBFD; M. Gammie, *Non-Discrimination and the Taxation of Cross-Border Dividends*, 2 World Tax J. 2, sec. 6. (2010), Journals IBFD; K. Lenaerts, *"United in Diversity" – also in Fiscalibus?*, in Hinnekens & Hinnekens eds., *supra* n. 46, at p. 628 et seq.; Mason, *supra* n. 3, at p. 86 et seq.; Knoll & Mason (2012), *supra* n. 3, at p. 1028 et seq.; Terra & Wattel, *supra* n. 1, at p. 63 et seq.; and Weber, *supra* n. 3, at p. 588 et seq.
50. HU: Opinion of Advocate General Kokott, 5 Sep. 2013, Case C-385/12, *Hervis Sport- és Divatkereskedelmi Kft. v. Nemzeti Adó- és Vámhivatal Közép-dunántúli Regionális Adó Főigazgatósága* para. 84, ECJ Case Law IBFD. *See also* Snell, *supra* n. 32, at p. 355 et seq.
51. *Gilly* (C-336/96), at paras. 46-48; UK: ECJ, 12 Dec. 2006, Case C-446/04, *Test Claimants in the Franked Investment Income Group Litigation v. Commissioners of Inland Revenue* para. 52, ECJ Case Law IBFD; *Block* (C-67/08), at para. 35; and DE: ECJ, 15 Sept. 2011, Case C-240/10, *Cathy Schulz-Delzers, Pascal Schulz v. Finanzamt Stuttgart III* para. 42, ECJ Case Law IBFD.
52. BE: ECJ, 8 Sept. 2005, Joined Cases C-544/03 and C-545/03 *Mobistar SA v. Commune de Fléron and Belgacom Mobile SA v. Commune de Schaerbeek* paras. 26-35, ECJ Case Law IBFD. *See also* S. Douma, *Non-discriminatory Tax Obstacles*, 21 EC Tax Rev. 2, p. 67 et seq. (2012); Vanistendael *supra* n. 25, at p. 208 et seq.; Terra & Wattel, *supra* n. 1, at p. 59; and Wattel (2008), *supra* n. 3, at p. 208 et seq.
53. M. Keen & K.A. Konrad, *The Theory of International Tax Competition and Coordination,* in A. Auerbach, R. Chetty, M. Feldstein & E. Saez eds., *Handbook of Public Economics,* vol. 5 (Elsevier 2013) p. 257, at p. 317 et seq.
54. W. Schön, *supra* n. 12, at p. 92 et seq.
55. *Lenz* (C-315/02), at para. 43; *Cadbury Schweppes* (C-196/04), at para. 49; BE: ECJ, 5 July 2012, Case C-318/10, *Société d'investissement pour l'agriculture tropicale SA (SIAT) v. État Belge* paras. 38 & 39, ECJ Case Law IBFD; and DE: ECJ, 26 Oct. 1999, Case C-294/97, *Eurowings Luftverkehrs AG v. Finanzamt Dortmund-Unna* para. 43, ECJ Case Law IBFD.
56. Cordewener, *supra* n. 15, at p. 23 et seq.; Schön, *supra* n. 12, at p. 98; and Weber, *supra* n. 3, at p. 601 et seq.

nor removes the disparities between the national legislations of the Member States. It requires an examination of the respective national legislation irrespective of whether the tax laws of another Member State apply to the same economic event and whether the interaction of the two tax jurisdictions results in double taxation or double deductions.

In their critical analysis of the Court's judicature, Graetz and Warren (2006 and 2012)[57] have read the ECJ's judgements in relation to taxation as a futile effort to seek simultaneous implementation of capital export neutrality (CEN) and capital import neutrality (CIN), thereby resulting in a situation where the Court has to make tax policy on behalf of the Member States. This critique has been rejected by other writers, either as being an incorrect interpretation of the ECJ's decisions in respect of taxation[58] or as being an incomplete analysis of the existing policy options for the Member States.[59]

In this context, Graetz and Warren (2006 and 2012) concur with this author's opinion[60] that a strictly unilateral non-discrimination test would leave the balance between EU requirements and national tax policy intact,[61] as both double tax burdens and disparities could then not be attacked by the ECJ as a legal issue. But they point out that the ECJ has abandoned this narrow perspective and embarked more and more on an "overall view" of taxation that includes tax effects both in the home Member State and in the host Member State to assess the validity of a national tax provision.[62] As a matter of fact, the ECJ has, in many instances, held that the compatibility of one Member State's legislation with the Internal Market might depend on existing legislation in other Member States, for example, the existence of an additional level of taxation or the other Member State's willingness to take into account specific circumstances that reduce the taxpayer's ability to pay.[63] It is this expansion of the perspective that lies at the heart of most controversial issues in EU tax law and that goes beyond what is required by the principle of neutrality as framed by the Internal Market.[64] This is now considered with regard to some major examples (*see* sections 2.3.4.2. and 2.3.4.3.).

2.3.4.2. Recognition of foreign tax burden

One of the main outcomes of the analysis in section 2.3.4.1. lies in the fact that the ECJ does not intervene when the "parallel exercise" of tax sovereignty by the Member States results in double taxation. In *Bouanich II* (Case C-375/12),[65] the ECJ addressed a provision under French law that provided for the overall tax burden on individual income to be capped at 50%. This was intended to address the cumulative effect of different taxes levied in France, but it did not take into account foreign taxes on income. Nevertheless, the ECJ held that the French tax authorities had to include in the calculation of the cap a Swedish withholding tax on profits distributed by a Swedish company to a French taxpayer. The ECJ did not relate this to its own jurisprudence in respect of double taxation, thereby indicating the unilateral character of the French tax measure.[66] This reasoning is not in line with the legal concept of tax neutrality under the fundamental freedoms. A true one-dimensional, non-discrimination test of a Member State's legislation with regard to taxation must regard the legislations of the other Member States to be virtually non-existent. In other words, there is no rule enshrined in EU law that says to a Member State: "you must not discriminate against foreign tax"![67] We shall return to this line of reasoning when we discuss cross-border imputation of corporate income tax (*see* section 6.).

A similar effect can be observed in the ECJ's judicature on the compatibility of withholding taxation on portfolio dividends by the source Member State. The ECJ's judgements have given rise to misunderstandings and uncertainty when the judges declared that a withholding tax on an outbound dividend payment, which in principle infringes on the free movement of capital, might be redeemed by the willingness of the residence Member State of the recipient to grant a tax credit for such withholding tax under a tax treaty.[68] This would result in the very strange effect that the choice of the residence Member State to grant a credit for the withholding tax instead of exempting the dividend income would be decisive regarding the compatibility of the source Member State's withholding tax with the fundamental freedoms.[69]

57. Graetz & Warren (2006), *supra* n. 3, at p. 1206 et seq. and Graetz & Warren (2012), *supra* n. 3, at p. 1118 et seq.
58. Van Thiel, *supra* n. 25, at pp. 85 & 87 and *supra* n. 21, at p. 189 et seq.
59. Knoll & Mason (2012), *supra* n. 3, at p. 1159 et seq. and Knoll & Mason (2013), *supra* n. 3, at p. 9 et seq.
60. Schön, *supra* n. 10, at p. 98.
61. Graetz & Warren (2006), *supra* n. 3, at p. 1220 et seq. and Graetz/Warren (2012), *supra* n. 3, at p. 1163 et seq.
62. Graetz & Warren (2006), *supra* n. 3, at p. 1220 et seq. and Graetz & Warren (2012), *supra* n. 3, at p. 1163 et seq. In this respect, the argument of Van Thiel, *supra* n. 21, conflicts with the existing jurisprudence of the ECJ.
63. For strong support of this view, *see* E.C.C.M. Kemmeren, *The Internal Market Approach Should Prevail over the Single Country Approach*, in Hinnekens & Hinnekens, *supra* n. 3, at p. 555. *See also* HJI Panayi, *supra* n. 17, at p. 165 et seq. and I.M. de Groot, *The ECJ's Conflicting Case Law on Neutralization*, 42 Intertax 11, p. 721 (2014).
64. Given this background, this article does not go deeper into the policy proposals of Knoll & Mason (2012), *supra* n. 3, at p. 1051 et seq., which is intended to ensure international "competitive neutrality" in an overall perspective that binds together the treatment of the host Member State and the home Member State either by granting an "ideal deduction" or a "full tax credit" on the part of the residence Member State.
65. FR: ECJ, 13 Mar. 2014, Case C-375/12, *Margaretha Bouanich v. Direction départementale des finances publiques de la Drôme* paras. 32-56, ECJ Case Law IBFD.
66. Id., at paras. 41, 42, 70 & 74.
67. Id., at para. 15. The only way to justify the outcome of this case is to say that the foreign tax must be taken into account insofar as French legislation itself grants a tax credit for this foreign tax, thereby transforming the foreign payment into a tax payment on behalf of France.
68. NL: ECJ, 8 Nov. 2007, Case C-379/05, *Amurta SGPS v. Inspecteur van de Belastingdienst/Amsterdam* paras. 79-81, ECJ Case Law IBFD; IT: ECJ, 19 Nov. 2009, Case C-540/07, *Commission of the European Communities v. Italian Republic* para. 36, ECJ Case Law IBFD; ES: ECJ, 3 June 2010, Case C-487/08, *European Commission v. Kingdom of Spain* paras. 58-62, ECJ Case Law IBFD; *Commission v. Germany* (C-284/09), at paras. 62-70; and BE: ECJ, 25 Oct. 2012, Case C-387/11, *European Commission v. Kingdom of Belgium* paras. 55-57, ECJ Case Law IBFD.
69. For a closer analysis, *see* K. Simader, *Withholding Taxes and the Fundamental Freedoms* p. 237 et seq. (Kluwer 2011); G. Kofler, *Tax Treaty "Neutralization" of Source State Discrimination under the EU Fundamental Freedoms?*, 65 Bull. Intl. Taxn. 12 (2011), Journals IBFD; P. Martin *Dividends and Withholding Taxes,* in Maisto ed., *supra* n. 37, at p. 25; HJI Panayi, *supra* n. 17, at p. 264 et seq.; Terra & Wattel, *supra* n. 1, at p. 471 et seq.; and Weber, *supra* n. 3, at p. 606 et seq.

2.3.4.3. No deduction: one-off deduction and double deduction?

The interdependence of domestic tax law and foreign tax law is even more visible in the ECJ's judicature on personal deductions and business expenditure, which tries to ensure that certain deductions and benefits are granted to the taxpayer on a once-only basis.[70] A unilateral view on tax neutrality would simply require each Member State to apply its domestic rules on deductions and similar benefits in a non-discriminatory fashion to cross-border situations. This is not what the ECJ has done since its famous judgement in *Schumacker* (C-279/93), when it stated for the first time that the source Member State must grant family allowances and similar tax benefits if the taxpayer is not in the position to enjoy these deductions in his residence Member State due to a lack of taxable income there.[71] A similar strand of judicature concerns cross-border deductibility of losses, where the ECJ has held that the residence Member State might be required to extend its beneficial rules on loss compensation for domestic subsidiaries and permanent establishments (PEs) to foreign subsidiaries and PEs to ensure a one-off deduction for the taxpayer if the taxpayer cannot deduct these losses in the source Member State.[72] The ECJ, in particular, grants the Member States limited discretion to take unilateral action against the possible "double deduction" of losses in both of the Member States involved.[73]

The willingness of the ECJ to take account of the interaction between two sets of tax legislation, typically that of the source Member State and that of the residence Member State, not only conflicts with the Court's own clear stance that double taxation is not an issue under EU law that should be resolved by the ECJ under the rules of the Internal Market. It is also an implicit deviation from two other fundamental statements made in the context of the fundamental freedoms.

First, the ECJ demonstrates a clear tendency in these judgements to allocate specific "duties" to the Member States involved. According to *Schumacker*, the residence Member State must, in principle, take into account family allowances and other personal circumstances. According to *Marks & Spencer* (C-446/03), the source Member State must, in principle, take into account business expenditure and losses with regard to the local investment and activities.[74] These assumptions are not compatible with the ECJ's general line that there are no pre-ordained assignments of taxing rights and obligations to Member States in the Internal Market.[75]

Second, the ECJ's judgements regularly imply that the tax laws in different Member States give regard to tax-relevant items of revenue, business expenditure and personal allowances in a, by and large, similar fashion.[76] But this assumption is not compatible with the ECJ's general line that the Member States are under no substantive constraints when they design their tax laws.[77] There is no EU Model Act for the taxation of income. There are no EU rules which provide that family deductions must be granted in every Member State to a specific extent or that loss carry-forwards and carry-backs must be granted in a harmonized manner.[78] Given this, the ECJ's judicature results in arbitrary results when taxpayers encounter disparities between the fiscal system of the Member States. The most striking example with regard to losses is *K* (C-322/11), where the ECJ declined to extend the Finnish loss relief to a factually "final" foreign loss incurred with regard to private investment only because the source Member State did not provide for any loss relief in the area of private investments at all, and, therefore, the relief mechanism of the source Member State could not be "exhausted".[79]

At this point, we should state that the concept of the Internal Market requires each Member State to ensure the equal treatment of domestic and cross-border events on a stand-alone basis. There is no obligation to remove double taxation and/or to level out disparities between national fiscal systems. In many judgements, the ECJ emphasizes that the Member States do not have to frame their tax legislation in accordance with legislation in other Member States. Given this, the strand of jurisprudence of the ECJ that makes the compatibility of national tax legislation dependent on the existence and the effect of tax rules in other Member States of the European Union is a constant source of uncertainty and arbitrariness.

2.4. No EU principle of one-off taxation

The ECJ should also avoid the implicit notion that, within the European Union, all items of revenue and expenditure in the comprehensive income derived by a taxpayer should

70. Knoll & Mason (2012), *supra* n. 3, at p. 103 et seq. and Kofler & Mason (2013), *supra* n. 3, at p. 80.
71. *Schumacker* (C-279/93), at paras. 36-38; NL: ECJ, 11 Aug. 1995, Case C-80/94, *G.H.E.J. Wielockx v. Inspecteur der Directe Belastingen* paras. 20-22, ECJ Case Law IBFD; DE: ECJ, 14 Sept. 1999, Case C-391/97, *Frans Gschwind v. Finanzamt Aachen-Außenstadt* paras. 26 & 27, ECJ Case Law IBFD; *De Groot* (C-385/00), at para. 89; SE: ECJ, 1 July 2004, Case C-169/03, *Florian W. Wallentin v. Riksskatteverket* para. 17, ECJ Case Law IBFD; *Beker* (C-168/11), at para. 44; and *Guido and Garcet* (C-303/12), at para. 43.
72. A. Garcia Prats, *Revisiting "Schumacker": Source, Residence and Citizenship in the ECJ Case Law*, in Richelle, Schön & Traversa eds., *supra* n. 30, at p. 15 et seq. and *supra* n. 3, at p. 437 et seq.
73. *Marks & Spencer* (C-446/03), at paras. 47 & 48; *Rewe Zentralfinanz* (C-347/04), at para. 47; *Lidl Belgium* (C-414/06), at paras. 35 & 36; and FI: ECJ, 21 Feb. 2013, Case C-123/11, *Veronsaajien oikeudenvalvontayksikkö and Valtiovarainministeriö v. A Oy* para. 14, ECJ Case Law IBFD.
74. *Marks & Spencer* (C-446/03), at paras. 53-56; FI: ECJ, 7 Nov. 2013, Case C-322/11, *K* paras. 56-58, ECJ Case Law IBFD; and *A Oy* (C-123/11), at para. 49.
75. Terra & Wattel, *supra* n. 1, at p. 465 et seq.; P.J. Wattel, *Fiscal Coherence, Fiscal Territoriality and Preservation of the (Balanced) Allocation of Taxing Power: What is the Difference?*, in Weber ed., *supra* n. 25, at p. 154 et seq. and (2008), *supra* n. 3, at p. 215 et seq.; and Weber, *supra* n. 3, at p. 591 et seq. and p. 599 et seq.
76. *De Groot* (C-385/00), at para. 98. For a critical view, *see* N. Mattson, *Does the European Court of Justice Understand the Policy behind Tax Benefits Based on Personal and Family Circumstances?*, 43 Eur. Taxn. 6, sec. 5. (2003), Journals IBFD.
77. A. Cordewener, *Personal Income Taxation of Non-Residents and the Increasing Impact of the EC Treaty Freedoms*, in Weber ed., *supra* n. 25, at p. 61 et seq.; W. Schön, *Die beschränkte Steuerpflicht zwischen europäischem Gemeinschaftsrecht und deutschem Verfassungsrecht*, 4 Internationales Steuerrecht 3, p. 121 et seq. (1995); F. Vanistendael, *Ability to Pay in European Community Law*, 23 EC Tax Rev. 3, p. 122 (2014); and Weber, *supra* n. 3, at p. 605.
78. *Renneberg* (C-527/06), at paras. 72-75.
79. *K* (C-322/11), at paras. 75-81.

be taxed or deducted only once.[80] The fundamental freedoms do not provide a framework for such one-off taxation of income. Such a framework would not only require a prohibition on juridical double taxation in the first place. It would also require a common set of rules for the measurement of income, which conflicts with the acceptance of ongoing "disparities" in national legislation, and it would require a common set of rules as to the allocation of taxing rights between the Member States. Last but not least, it would require a mechanism under which tax-increasing mismatches, for example, taxable income is derived in Member State A and deductible expenditure is incurred in Member State B,[81] were mechanically resolved.[82] Such a framework cannot be found in the EU Treaties.

The preferred approach which abandons the concept of one-off taxation and which seeks unilateral neutrality works both to the benefit and to the detriment of the taxpayer. The Member States should accept that, from this unilateral perspective regarding the fundamental freedoms, the possibility of "double-dipping" in respect of expenditure in two Member States, as such, does not justify discrimination against cross-border activities,[83] an outcome which the ECJ consciously welcomed in *Imfeld and Garcet* (Case C-303/12).[84] The taxpayer should, in turn, accept that the desire to locate a one-off deduction in respect of expenditure at least "somewhere" in the European Union does not put an enforceable liability on the Member States involved.

2.5. Coherence and tax neutrality

While issues of double-dipping and one-off taxation refer to the interplay between the two tax jurisdictions involved, the widely debated concept of "coherence" is strongly linked to the unilateral neutrality test under the non-discrimination prohibition. Since 1992,[85] the ECJ has reiterated its view that unequal treatment can be justified if the "coherence" of national tax legislation requires so.[86] This concept of "coherence" is built on the assumption that the mechanics of national tax legislation often gives rise to a "direct link" between a tax benefit and a tax disadvantage.[87] The clearest example is the symmetry between business revenue and business expenditure, the aggregate of which composes the profit or loss of a business entity. The ECJ has continuously held that a Member State is not prevented from denying a tax advantage to a foreign resident or the participants of a cross-border event if the corresponding tax disadvantage would not fall on the same taxpayer in the same jurisdiction.

This argument is clearly based on the Internal Market's objective of realizing unilateral tax neutrality with regard to one Member State's tax legislation. It clarifies that the non-discrimination principle is not intended to place the "international" taxpayer in a position that is more beneficial than the treatment of the taxpayer in a purely domestic situation.[88] The "free mover" is not entitled to become a "free rider". In principle, the coherence test can and must be executed without considering the treatment of this taxpayer in another jurisdiction.[89] It is a self-evident constituent of the non-discrimination principle as applied to domestic legislation in one Member State.

Nevertheless, since its 1995 judgement in *Wielockx* (Case C-80/94), the ECJ has stated that a Member State cannot use "coherence" as a ground of justification if it has voluntarily waived its right to tax income from specific sources under a tax treaty. In such circumstances, the Member State in question must grant equal treatment with regard to deductions and other tax benefits, even if the advantage of the taxable event resides with another Member State. "Micro-coherence", as it has been called, is replaced by "macro-coherence". According to the ECJ, coherence is "shifted to another level, that of reciprocity of the rules applicable in the Contracting States".[90] The Member State in question is presumed to enjoy a corresponding stream of revenue from taxpayers in the reverse situation.[91]

At first glance, one might read this line of judgements to establish again the interdependence between the tax treatments applied by two Member States involved. But this is not necessarily true. Rather, the ECJ, in these judgements, maintains the unilateral perspective, thereby replacing in this one-sided approach the "direct link" between expenditure and income of an individual taxpayer with a "link" between certain types of expenditure and certain types of income arising from cross-border taxpayer activities in general. But one should not overestimate the true content of "macro-coherence". The mutual waiver of taxing rights under a tax treaty does not give rise to new taxing rights

80. Knoll & Mason (2012), *supra* n. 3, at p. 1076 et seq. and p. 1104 et seq.; Lang (2006), *supra* n. 3, at p. 426 and (2009), *supra* n. 3, at p. 99; and Wattel, *supra* n. 75, at p. 144 et seq.: "always somewhere principle").
81. *See Bosal* (C-168/01), at paras. 23-27, where the ECJ had no issue with the fact that Council Directive 90/435/EEC of 23 July 1990 on the Common System of Taxation Applicable in the Case of Parent Companies and Subsidiaries of Different Member States, OJ L 225 (1990), EU Law IBFD [hereinafter: EU Parent-Subsidiary Directive 90/435], grants the Member States the discretion to limit or deny the deductibility of costs related to participations.
82. This is what Terra & Wattel, *supra* n. 1, at p. 65 et seq., call "dislocations".
83. M. Lang, *Has the Case Law of the ECJ on Final Losses Reached the End of the Line?*, 54 Eur. Taxn. 12, sec. 3. (2014), Journals IBFD. For the opposing view, *see* Kemmeren, *supra* n. 63, at p. 563 and Van Thiel, *supra* n. 21, at p. 185.
84. *Imfeld and Garcet* (C-303/12), at paras. 77-79. Critical, *see* B. Peeters, *Mobility of EU Citizens and Formulary Taxation: A Hard to Reconcile Combination,* 23 EC Tax Rev. 3, p. 118 (2014).
85. BE: ECJ, 28 Jan. 1992, Case C-204/90, *Hanns-Martin Bachmann v. Belgian State* paras. 21-23, ECJ Case Law IBFD and BE: ECJ, 28 Jan. 1992, Case C-300/90, *Commission of the European Communities v. Kingdom of Belgium* paras. 14-21, ECJ Case Law IBFD.
86. *Emerging Markets* (C-190/12), at para. 91; *SCA* (Joined Cases C-39/13, C-40/13 and C-41/13), at para. 33; FI: ECJ, 8 Nov. 2012, Case C-342/10, *European Commission v. Republic of Finland* para. 49, ECJ Case Law IBFD; *K* (C-322/11), at paras. 64-71; *Aberdeen Property Fininvest* (C-303/07), at paras. 71 & 72; DE: ECJ, 23 Oct. 2008, Case C-157/07, *Finanzamt für Körperschaften III in Berlin v. Krankenheim Ruhesitz am Wannsee-Seniorenheimstatt GmbH* paras. 40-49, ECJ Case Law IBF; and FR: ECJ, 27 Nov. 2008, Case C-418/07, *Société Papillon v. Ministère du budget, des comptes publics et de la fonction publique* paras. 41-55, ECJ Case Law IBFD. For a critical view as to the fuzziness of the concept, *see* Lang (2006), *supra* n. 3, at p. 424 et seq. and Wattel, *supra* n. 75, at p. 141 et seq.
87. Lenaerts, *supra* n. 1, at p. Q 74 et seq.
88. A. Cordewener, *Europäische Grundfreiheiten und nationales Steuerrecht* p. 958 et seq. (Otto Schmidt 2002).
89. *Emerging Markets* (C-190/12), at para. 94.
90. *Wielockx* (C-80/94), at paras. 24 & 25.
91. FI: ECJ, 3 Oct. 2002, Case C-136/00, *Rolf Dieter Danner* paras. 40 & 41, ECJ Case Law IBFD; *X and Y* (C-436/00), at paras. 53-57; LU: ECJ, 15 July 2004, Case C-242/03, *Jean-Claude Weidert and Élisabeth Paulus v. Ministre des Finances* para. 25, ECJ Case Law IBFD; and *Commission v. Belgium* (C-296/12), at paras. 34-40.

for the parties to the tax treaty. The contracting states are not extending their jurisdiction beyond the scope of their entitlements before the tax treaty was concluded. The only quid pro quo they receive for granting an exemption to the other state is the waiver of the other state's taxing rights, i.e. each state country is in the position to exercise their own taxing rights without having to consider a deduction or a credit for any foreign tax.[92] Conversely, "macro-coherence" does not eradicate taxing rights for the state in question. It only forces that state to grant relief for tax levied by the other contracting state.

The broad approach of "macro-coherence" has resulted in the widespread perception that the Member States can rarely invoke this concept successfully. Yet, in recent years, the ECJ has reinforced the concept of coherence in several cases, including cross-border loss compensation. This increased effect of "cohesion" complements the rise of "territoriality" and the "balanced allocation of taxing powers" as central notions of EU tax law.[93] This is no accident, as the interaction between "coherence" and "territoriality" is the core of the unresolved conflict between tax neutrality and national tax legislation, i.e. the territorial limitation of the taxing powers of the Member States.

3. Territoriality and the Internal Market

3.1. Respect for territoriality in EU law

When we speak of territorial taxation, we address a situation where the jurisdiction to tax is based on or limited to persons and events present in a given geographical territory.[94] In this sense, most current taxation systems have a territorial nature. With regard to direct taxation, countries tax income, wealth or inheritance on the basis of a person being resident on the territory of a given country or on the basis of an economic event taking place in the territory of a given country.[95]

The opposite concept, i.e. taxation on the basis of nationality, has largely been abandoned and has its major area of application outside the European Union, for example, in US tax law.[96] While citizenship taxation has lost ground in the European Union, one should not overlook that a comprehensive implementation of pure personal taxation by all of the Member States would result in a world close to the ideal of cross-border neutrality referred to in section 2. That is, each person would only be taxed once on their worldwide income, disregarding dual nationality for the sake of the argument, thereby treating domestic and foreign income alike while simultaneously removing any form of double taxation.[97] The only non-neutral element in this world would be disparities between legislations of the Member States that might encourage nationals of the Member States to change citizenship to benefit from a more taxpayer-friendly jurisdiction. A similar effect can be achieved by implementing pure residence taxation, thereby disregarding any kind of source taxation.[98] In the current state of affairs, though, it is the territorial compartmentalization that contributes largely to the manifold obstacles to optimal allocation of resources in the tax world.

The EU Treaties do not only recognize the ongoing sovereignty of the Member States in fiscal matters. They also recognize the preservation of the "territorial integrity" of each and every Member State as a primary goal of EU policy.[99] The Member States are not just institutional centres of competence and decision-making. They exercise authority over a geographical territory. Consequently, they are entitled to tax individuals and companies that are resident and economic events that arise in their territory. It is an inherent element of territorial taxation that drives a wedge between persons resident inside and outside the territory and activities performed and assets located inside and outside the territory.

3.2. The legal basis for territorial taxation

What is the legal basis for territorial taxation giving rise to unequal treatment of domestic and international situations? There are basically the following three sets of rules that induce states to distinguish between taxable events inside and outside their geographical borders:[100]

(1) There are cases where international customary law prohibits a state extending its tax claim beyond its own territorial boundaries. It is common ground that there must be a "genuine link" between a state and a person or an economic event justifying the tax claim.[101] Such a genuine link can be provided by a personal attachment to a state, i.e. nationality, or by some sort of economic allegiance. Briefly, a state is, in general, not entitled to tax foreign residents on their foreign-based assets or income.[102] The ECJ has emphasized this concept in the following two situations: (i) limited tax liability of foreign residents with regard to their domestic income;[103] and (ii) limited access to profits derived by the foreign activities of foreign subsidiaries at the level of the parent

92. This point is stated very clearly in *Weidert and Paulus* (C-242/03), at para. 25.
93. J. Kokott & H.Ost, *Europäische Grundfreiheiten und nationales Steuerrecht,*22 Europäische Zeitschrift für Wirtschaftsrecht 13, p. 500 et seq. (2011).
94. Monsenego, *supra* n. 5, at p. 10 et seq.
95. W. Schön, *Persons and Territories: on the International Allocation of Taxing Rights*, Brit. Tax Rev. 6, p. 554 et seq. (2010). The missing clarity of the ECJ jurisprudence when it comes to the application of the principle of territoriality is described by Garcia Prats, *Revisiting "Schumacker"*, *supra* n. 72, at p. 10 et seq.
96. For the latest account, *see* M. Kirsch, *Revisiting the Tax Treatment of Citizens Abroad: Reconciling Principle and Practice*, 16 Fla. Tax Rev., p. 117 (2014) .
97. Taxation on a nationality basis is compatible with the fundamental freedoms. *See Van Hilten* (C-513/03), at para. 46 (inheritance taxation of nationals irrespective of their territorial residence).
98. Taxation on a residence basis is also compatible with the fundamental freedoms. *See Block* (C-67/08), at para. 35 (inheritance taxation).
99. Art.4(2), second sentence TEU.
100. Douma, *supra* n. 49, at p. 523 et seq.
101. F.A. Mann, *The Doctrine of Jurisdiction in International Law Revisited after Twenty Years,* 186 Recueil des Cours, p. 9 (1984) and *Further Studies in International Law* p. 13 et seq. (Oxford 1990). On the influence of international customary law on EU law, *see* Wouters & Vidal, *supra* n. 46, at p. 998.
102. For the long and more differentiated story, *see* Monsenego *supra* n. 5, at p. 31 et seq. and p. 52 et seq.
103. LU: ECJ, 15 May 1997, Case C-250/95, *Futura Participations SA and Singer v. Administration des contributions* paras. 18-22, ECJ Case Law IBFD.

company.[104] As EU law is not in the position to remove such limitations as defined by international customary law, the Internal Market does not require the Member States to disregard the resulting constraints in providing for equal treatment.[105]

(2) There are cases where two or more states have agreed to divide taxing rights among them on the basis of a bilateral or multilateral tax treaty.[106] Such an agreement may result in a reinforcement of territorial taxation, as the source state might give up the right to tax some of the income arising in its territory, while the residence state might waive its right to worldwide income taxation with regard to some categories of income sourced in another state. One might ask whether or not this form of "voluntary" compartmentalization is compatible with the requirements of the Internal Market, as these agreements and the implementing domestic legislation fall within the scope of the fundamental freedoms. Yet we must recognize that the objective of these tax treaties is compatible with the efficiency objectives of the Internal Market, thereby reducing double taxation as a major obstacle to cross-border traffic.[107] This position was explicitly stated in article 225 of the EEC Treaty and article 293 of the EC Treaty, which encouraged Member States to conclude tax treaties.[108] While this explicit statement was repealed when the Lisbon Treaty entered into force, it nonetheless represents the unchanged policy objective of the Internal Market.[109] As the ECJ has declared itself to be not in the position to divide taxing rights among the Member States, it is more than welcome when the Member States realize consensus in these matters themselves.

(3) There are cases of unilateral renouncement of taxing rights with regard to other states. A residence state might introduce a one-sided exemption for foreign-source income under its domestic tax legislation, as, for example, France does for corporate income taxation and Germany for municipal trade tax. A source state might waive withholding taxation on outbound interest, thereby distinguishing between domestic and foreign residents, as Germany has done since the 1920s. As these unilateral waivers generally contribute to the abolition of double taxation, they should not, in principle, be in breach of the Internal Market.[110] It should not make a difference from an EU perspective as to whether double taxation is abolished on a bilateral or a unilateral basis.

104. *Marks & Spencer* (C-446/03), at para. 39.
105. Id.
106. Lenaerts, *supra* n. 1, at p. Q 66 et seq. and Monsenego, *supra* n. 5, at p. 190 et seq.
107. Kemmeren, *supra* n. 12, at p. 158 et seq.
108. FR: ECJ, 14 Dec. 2006, Case C-170/05, *Denkavit Internationaal BV, Denkavit France SARL v. Ministre de l'Économie, des Finances et de l'Industrie* para. 43, ECJ Case Law IBFD; *ACT Group Litigation* (C-374/04), at para. 51; *Kerckhaert Morres* (C-513/04), at paras. 21-23; and *Levy and Sebbag* (C-540/11), at para. 27.
109. Terra & Wattel, *supra* n. 1, at p. 14 et seq.
110. Lenaerts, *supra* n. 49, at p. 628 et seq.

3.3. The effect of territorial limitation on tax neutrality

This gives rise to the theoretical question of whether or not the concept of tax neutrality requires the Member States to extend their tax jurisdiction to the whole territory of the European Union to provide for cross-border equal treatment of all flows of persons, goods, services and capital within the Internal Market.[111] This is clearly not the case, as far as a Member State simply decides not to tax a given asset or item of income.[112] This is because the fundamental freedoms do not require the Member States to treat domestic and cross-border situations alike in any respect. They only require the Member States not to treat domestic situations more advantageously than cross-border situations. There is no provision in the EU Treaties that prohibits "reverse discrimination".[113] It does not infringe on the fundamental freedoms if a Member State taxes its own residents or nationals on their worldwide income, while it taxes foreign residents only on their territorial income.[114] And it is also compatible with the Internal Market if the residence Member State does not tax its own residents on (all or some) foreign income, on the basis of bilateral or unilateral legislation, to reduce the effect of double taxation.[115]

In its jurisprudence, the ECJ has, in general, accepted that the Member States are neither entitled nor required to extend their tax jurisdiction to all economic events taking place within the boundaries of the European Union to provide for equal treatment.[116] From this perspective, in several judgements on withholding taxation, the ECJ has explicitly drawn a line between the allocation of taxing powers as such and the exercise of these powers.[117] The Member States are free to allocate taxing powers between them on a territorial basis, i.e. either unilaterally in the context of domestic legislation or bilaterally under a tax treaty. But the Member States must exercise the resulting powers in a non-discriminatory fashion both with regard to domestic and cross-border situations.

3.4. Must Member States grant deductions and other tax benefits on an EU-wide basis?

It is evident that there is hardly any jurisprudence of the Court on the question whether or not a resident or non-resident taxpayer has a right to be taxed on foreign-source income. However, the reports of ECJ case law are full of examples of taxpayers striving for deductions and

111. Terra & Wattel, *supra* n. 1, at p. 455 et seq.
112. Wattel (2008), *supra* n. 3, at pp. 208 & 215 and Weber, *supra* n. 3, at p. 594.
113. Schön, *supra* n. 12, at p. 99 and P. Vidal Matos, *Reverse Discrimination and Direct Taxation in the EU*, in *EU Income Tax Law: Issues for the Years Ahead* p. 197 (D. Weber ed., IBFD 2013), Online Books IBFD.
114. Graetz & Warren (2012), *supra* n. 3, at p. 1156 et seq.
115. Knoll & Mason (2012), *supra* n. 3, at p. 1075.
116. Lenaerts, *supra* n. 1, at p. Q 62 et seq.; and P. Pistone, *The Impact of Community Law on Tax Treaties: Issues and Solutions* p. 175 et seq. (Kluwer 2002) and *Ups and Downs in the Case Law of the European Court of Justice and the Swinging Pendulum of Direct Taxation*, 36 Intertax 4, p. 146 (2008).
117. *Emerging Markets* (C-190/12), at para. 59; *Aberdeen Property Fininvest* (C-303/07), at paras. 66-70; *Amurta* (C-379/05), at para. 38; *Commission v. Italy* (C-540/07), at paras. 51-54; *Commission v. Germany* (C-284/09), at paras. 55-58; *Commission v. Belgium*, at paras. 46-51; and *Denkavit Internationaal* (C-170/05), at para. 44. *See also* Lenaerts, *supra* n. 49, at p. 628 et seq.

other tax benefits that they are denied, as the underlying income is not or not fully taxable in the respective state. In other words, nobody complains about income not being taxable in full or in part, but everybody complains about any resulting denial of deductions or similar advantages. Major examples include low-bracket tax rates, family allowances and personal deductions in respect of limited tax liability, imputation of the foreign corporate income tax in respect of domestic shareholders, compensation for source Member State losses in the residence Member State and vice versa, the application of anti-avoidance measures to business expenditure, such as intra-group interest payments, and transfer prices in respect of intra-group supplies. In *Kronos* (Case C-47/12), the taxpayer went so far as to reject a tax exemption of foreign dividends and to demand full taxation to benefit from both the underlying tax credit and the availability of the dividend income for compensation of losses incurred at home.[118]

When it comes to the assessment of these situations, we must remember that the rules that limit the tax jurisdiction of a Member State in a territorial fashion, i.e. international customary law, bilateral and multilateral agreements as well as unilateral legislation, do not prevent any Member State from granting deductions and similar benefits to taxpayers.[119] No Member State is in the position to claim that it cannot reduce its tax claim on foreign transactions or non-resident taxpayers to the full extent available for domestic transactions or taxpayers.

The key question is to what extent such a denial is, in the language of the ECJ, "justified" under EU law. In this vein, the ECJ has recurrently recognized the territorial limits of taxation to legitimize unequal treatment and has expanded the scope of this justification substantially in recent years. In the 1990s, the ECJ stated that territorial limitations could lead to the result that foreign and domestic taxpayers, activities or investments are not in a "comparable" situation. Some years later, the concept of "territoriality" itself was welcomed among the justifications accepted by the ECJ.[120] Over the last 10 years, the ECJ has both resuscitated the concept of "coherence" and introduced the concept of the "balanced allocation of taxing powers" to legitimize unequal treatment related to the territorial allocation of taxable assets and activities. Last but not least, territoriality has been emphasized by the ECJ when the Member States attempt to counter "abusive" transactions. Unequal treatment of tax avoiders is, according to the ECJ, justified to protect a Member State's right to tax income "generated by activities carried out on the national territory".[121]

3.5. Territoriality and exit taxation

The most striking example of the increasing importance attached to the territorial concept of taxation can be seen in the change of the ECJ's judicature on taxes levied on the emigration of individuals and corporations from one Member State to another. Considering the time-honoured absolute prohibition on customs duties and charges with an equivalent effect on inbound and outbound transfer of goods under article 30 of the TFEU, one may wonder as to what extent the fundamental freedoms allow the Member States to levy an "exit tax" on the migration of natural and legal persons between jurisdictions. The early judgements of the ECJ in this area clearly supported the view that the emigration of a taxpayer as such is a non-event under EU law.[122] According to this jurisprudence, the home Member State may be entitled to tax income generated on its territory at a later stage, but the act of emigration as such does not empower that Member State to accelerate taxation before the realization of income, to ask for collateral or to charge interest on the tax claim from the day of emigration.[123] This line of reasoning was reversed in 2011 in *National Grid Indus* (Case C-371/10) when the ECJ held that the movement of a company from one territory to another territory gave rise to increased obligations under substantive and procedural tax law.[124] This seismic shift towards the fiscal interests of the Member States[125] was expanded in subsequent decisions, according to which the home Member State may introduce specific taxable events to capture unrealized gains at an early stage, irrespective of whether or not these gains would be realized by the taxpayer at a later stage.[126] The territories of the Member States, so it appears, are encircled by tax borders, which justify increased or accelerated direct taxation.

3.6. Territoriality and the priority of taxing rights

One last feature of territoriality that deserves attention at this point is the fact that more and more often the ECJ regards territoriality to be not just a limitation to national tax sovereignty established by international and national law. Rather, the ECJ conceives of the concept of territoriality as granting priority to a specific Member State, for example, to the source Member State over the residence Member State.[127] Such a concept is not based on international law.[128] This dimension of territoriality is particularly

118. *Kronos* (C-47/12), at paras. 10-15.
119. Very clear in *Renneberg* (C-527/06), at paras. 52 & 53.
120. *See also* M. Wathelet, *Tax Sovereignty of the Member States and the European Court of Justice: New Trends or Conformation?* in Hinnekens & Hinnekens eds., *supra* n. 3, at p. 918 et seq.
121. *Cadbury Schweppes* (C-196/04), at para. 55 and NO: EFTA Court, 9 July 2014, Joined Cases E-3/13 and E-20/13, *Fred. Olsen and Others v. the Norwegain State*, para. 166.
122. *X and Y* (C-436/00), at paras. 46-65; BE: ECJ, 8 June 2004, Case C-268/03, *Jean-Claude De Baeck v. Belgian State* paras. 17-28, ECJ Case Law IBFD; *De Lasteyrie du Saillant* (C-9/02), at paras. 45-58; *N* (C-470/04), at paras. 31-66; and SE: ECJ, 18 Jan. 2007, Case C-104/06, *Commission of the European Communities v. Kingdom of Sweden* paras. 14-35, ECJ Case Law IBFD.
123. Most explicitly, *see N* (C-470/04), at para. 46.
124. NL: ECJ, 29 Nov. 2011, Case C-371/10, *National Grid Indus BV v. Inspecteur van de Belastingdienst Rijnmond/kantoor Rotterdam* paras. 49-85, ECJ Case Law IBFD.
125. T. Kaye, *Direct Taxation in the European Union: From Maastricht to Lisbon*, 35 Fordham Intl. L. J., p. 1237 (2012); Terra & Wattel *supra* n. 1, at p. 505 et seq.; and P.J. Wattel, *Exit Taxation in the EU/EEA Before and After* National Grid Indus, Tax Notes Intl. p. 371 (30 Jan. 2012).
126. *DMC* (C-164/12), at paras. 48-68; *Commission v. Spain* (C-64/11), at paras. 31-39; NO: EFTA Court, 3 Oct. 2012, Case E-15/11, *Arcade Drilling AS v. Staten v/Skatt Vest* paras. 91-105; DK: ECJ, 18 July 2013, Case C-261/11, *European Commission v. Kingdom of Denmark* para. 37, ECJ Case Law IBFD; PT: ECJ, 6 Sept. 2012, Case C-38/10, *European Commission v. Portuguese Republic* paras. 21-34, ECJ Case Law IBFD; and NL: ECJ, 31 Jan. 2013, Case C-301/11, *European Commission v. Kingdom of the Netherlands* paras. 12-23, ECJ Case Law IBFD.
127. Garcia Prats, *supra* n. 72, at p. 12 et seq.
128. Monsenego, *supra* n. 5, at p. 42 et seq.

visible in the ECJ's jurisprudence on tax avoidance and "purely artificial arrangements", where the Court explicitly links the attempts to counter abusive tax planning to the right of each Member State to tax income "derived within its territory".[129] The ECJ and the EFTA Court have held that even controlled foreign company (CFC) legislation is justified within the European Economic Area (EEA), insofar as it protects the right of a Member State to tax income "generated by activities within its territory". The Member States are entitled to counter artificial arrangements where foreign entities are "not carrying out any genuine economic activity in the territory of the host state".[130] This statement extends the notion of "territoriality" beyond its natural place for the purposes of international taxation.

3.7. Territoriality, sovereignty and the imperfect Internal Market

The increasing importance of territoriality in the jurisprudence of the ECJ signals a shift in the underlying concept of the Internal Market in tax matters. In its previous judicature and in accordance with the economic concept of optimal allocation of resources as set out in the EU Treaties, the ECJ conceived of the Internal Market as a space without borders where tax provisions are not allowed to interfere with the decisions of taxpayers to engage in cross-border economic activities. In their more recent decisions, the ECJ has recognized the alleged relevance of these borders, in particular with regard to exit taxation or to loss compensation. To borrow a metaphor from Vanistendael (2003), the ECJ is currently moving from the concept of the Internal Market as one large snooker table spanning the area of the European Union as a whole to the concept of the Internal Market as a room containing twenty-eight small snooker tables where access to these separate tables is granted on a non-discriminatory basis.[131] Looking at the fundamentals of the Internal Market, this is a step backward to what academic writers have labelled an "imperfect internal market".[132]

In these judgements, the ECJ appears to link the new emphasis on territoriality to the preservation of tax sovereignty for the Member States in general. But this is a confusion of categories. Tax sovereignty implies the fundamental right of the Member States to invent tax types, set tax rates and define the tax base as they see fit. Tax sovereignty must be exercised within the framework of the fundamental freedoms. Neither does the recognition of tax sovereignty grant priority rights to source Member States over residence Member States in taxing income generated on their territory nor does it grant them the right to erect tax walls against outbound or inbound cross-border activities and assets to protect public revenue.[133] Irrespective of whether territorial limitations are based on international customary law, bilateral conventions or unilateral legislation, the limits of territoriality provide a mandatory or voluntary constraint to the fiscal autonomy of a Member State and do not extend its powers with regard to other Member States or taxpayers. Insofar, the only question to ask is to what extent these territorial limits to a Member State's tax jurisdiction can justify individual departures from the overall requirement of equal treatment for domestic and cross-border activities.

4. Towards a Reconciliation of Neutrality and Territoriality

4.1. The question of comparability

4.1.1. Limited tax liability

A major deviation from the concept of cross-border tax neutrality as ensured by the fundamental freedoms is the fact that the ECJ has for 20 years insisted on the phrase to the effect that the position of a non-resident taxpayer who is subject to limited tax liability in a Member State is, in general, not comparable to the position of a resident taxpayer who is subject to unlimited tax liability.[134] This is a harsh statement, as it appears not only to undermine fundamentally the effect of the principle of non-discrimination in tax cases, but also, read at face value, it explicitly requests a different treatment of resident and non-resident taxpayers in a generalized fashion. Given that the main purpose of the Internal Market is to provide for a free flow of economic factors and given the major role tax neutrality plays in this context, this blunt concept of non-comparability is clearly overreaching. In practice, it may provide some comfort, but not a principled solution, in all matters regarding taxation of income at source, as the ECJ has clearly supported equal treatment of a non-resident deriving income from a domestic source and a resident deriving similar income from a domestic source.[135] The

129. *Felixstowe* (C-80/12), at paras. 30 & 33; PT: ECJ, 3 Oct. 2013, Case C-282/12, *Fazenda Pública v. Itelcar – Automóveis de Aluguer, Lda* para. 34, ECJ Case Law IBFD; *K* (C-322/11), at para. 61; *Aberdeen Property* (C-303/07), at para. 64; UK: ECJ, 23 Apr. 2008, Case C-201/05, *The Test Claimants in the CFC and Dividend Group Litigation v. Commissioners of Inland Revenue* para.77, ECJ Case Law IBFD; and AT: ECJ, 4 Dec. 2008, Case C-330/07, *Jobra Vermögensverwaltungs-Gesellschaft mbH v. Finanzamt Amstetten Melk Scheibbs* paras. 32 & 33, ECJ Case Law IBFD.
130. *Cadbury Schweppes* (C-196/04), at para. 68 and *Olsen* (Joined Cases E-3/13 and E-20/13), at para. 166 et seq.
131. Vanistendael, *supra* n. 15, at p. 139 and *supra* n. 25, at p. 191 et seq.
132. D. Edward & R. Lane, *Edward & Lane on European Union Law* p. 461 et seq. (Elgar 2013) and J. Englisch, *Taxation of Cross-Border Dividends and EC Fundamental Freedoms,* 38 Intertax 4, p. 197 (2010).
133. Van Thiel, *supra* n. 21, at p. 182 et seq.
134. *Schumacker* (C-279/93), at paras. 31-34; *Wielockx* (C-80/94), at paras. 17-19; *Asscher* (C-107/94), at paras. 41-44; *Gilly* (C-336/96), at paras. 49 & 50; *Gschwind* (C-391/97), at paras. 22 & 23; *Gerritse* (C-234/01), at paras. 43 & 44; *Wallentin* (C-169/03), at paras. 15 & 16; FI: ECJ, 9 Nov. 2006, Case C-520/04, *Pirkko Marjatta Turpeinen* paras. 26-28, ECJ Case Law IBFD; DE: ECJ, 25 Jan. 2007, Case C-329/05, *Gerold Meindl and Christine Meindl-Berger v. Finanzamt Dinslaken 25* para. 23, ECJ Case Law IBFD; and ES: ECJ, 6 Oct. 2009, Case C-562/07, *Commission of the European Communities v. Kingdom of Spain* para. 46, ECJ Case Law IBFD.
135. *Avoir Fiscal* (270/83), at para. 19; *Emerging Markets* (C-190/12), at paras. 58-69; *Commission v. Finland* (C-342/10), at para. 37; *Aberdeen Property* (C-303/07), at para. 43; GR: ECJ, 29 Apr. 1999, Case C-311/97, *Royal Bank of Scotland plc v. Elliniko Dimosio* paras. 27-29, ECJ Case Law IBFD; *Saint-Gobain* (C-307/97), at paras. 47 & 48; *Gerritse* (C-234/01); *Bouanich I* (C-265/04), at paras. 39-41; DE: ECJ, 6 July 2006, Case C-346/04, *Robert Hans Conijn v. Finanzamt Hamburg-Nord* para. 24, ECJ Case Law IBFD; *Denkavit Internationaal* (C-170/05), at paras. 25-29; BE: ECJ, 22 Mar. 2007, Case C-383/05, *Raffaele Talotta v. Kingdom of Belgium* paras. 25 & 26, ECJ Case Law IBFD; *Commission v. Spain* (C-562/07), at paras. 48-58; *Commission v. Spain* (C-487/08), at paras. 50-53; and DE: ECJ, 31 Mar. 2011, Case C-450/09, *Ulrich Schröder v. Finanzamt Hameln* paras. 40-47, ECJ Case Law IBFD. For inheritance taxation, *see* NL: ECJ, 11 Dec. 2003, Case C-364/01, *The heirs of H. Barbier v. Inspecteur van de Belastingdienst Particulieren/Ondernemingen buitenland te Heerlen* para. 38, ECJ

ECJ has, however, reduced over time its broad assertion of non-comparability for non-residents to cases where the availability of personal deductions and the recognition of family circumstances are at stake.[136]

On closer examination, the issue is not whether residents and non-residents are, in principle, in a non-comparable situation.[137] The *differentia specifica* is the reduced territorial scope of tax jurisdiction and nothing else. The core substantive question is, therefore, whether or not a reduced geographic coverage of taxability that results in a less-than-full taxation of a person's income may have effects on other items, such as deductions, credits or tax rates. Against this background, it seems to be adequate to target this question in a sophisticated manner, i.e. by identifying specific grounds of justification and assessing the proportionality of tax measures. The Member State must show a particular relationship between the territorial limitations to the Member State's taxing rights and the ensuing disadvantage for the taxpayer. In order to give full effect to the concept of tax neutrality in the TEU, one should, therefore, reverse the burden of proof and start from the assumption that resident and non-resident taxpayers are in a comparable situation. The same practical result can be achieved by the recent proposal of Advocate General Kokott[138] to dismiss as such the comparability test as it stands today.

4.1.2. Unlimited tax liability

The corresponding question is whether or not the state of residence is required in principle to treat foreign investment and activities in the same manner as domestic investment and activities. From the perspective of tax neutrality and the mechanics of the Internal Market, it should be clear that the application of worldwide tax liability to local taxpayers results in general comparability of domestic and outbound activities or investment, notwithstanding the fact that the public revenue from foreign sources is only spent by the government on domestic purposes.[139] The case is not so evident if the residence Member State unilaterally limits its taxing rights to its own territory or if it enters into a tax treaty that exempts foreign-source income or assets. In many judgements, the ECJ has, nevertheless, recognized the comparability of domestic and outbound cases and has considered the problem of territoriality only when it comes to the justification of unequal treatment.[140] But in its recent decisions in *Nordea Bank* (Case C-48/13), the ECJ went so far to state that, for the purpose of residence taxation, income streams from domestic and from exempt foreign sources are, in general, not comparable, unless the foreign income is explicitly subject to unlimited taxation.[141] This statement is likewise too strong. The residence Member State is entitled to waive its right to the worldwide taxation of income and assets, but this waiver does not suspend its obligation to ensure tax neutrality as far as possible. The Member State must demonstrate that there is a justifying link between the reduced range of tax jurisdiction and the denied tax advantage. This results in more sophisticated deliberations at the level of justification.

The manifold cases where the residence Member State voluntarily limits its tax claim to domestic activities or exempts certain foreign activities reveal that the territorial limitation of taxing rights is not just a matter to be considered in the case of limited tax liability and source taxation. The wide issue of tax treaties demonstrates a tendency to allocate taxing rights on a territorial basis to both the residence state and the source state without granting one of them supremacy. Worldwide taxation and foreign tax credits are on the retreat, while major states more and more embrace territorial systems for taxation of residents. Consequently, the concept of "territoriality" and its legitimizing power can affect both residence and source states in a similar fashion. The main issue is to what extent the residence state and the source state may deny certain tax benefits to taxpayers, as these are not taxable in that state with regard to their worldwide income.

4.2. Territoriality, balanced allocation of taxing powers and coherence

4.2.1. Opening comments

In the jurisprudence of the ECJ, three concepts have been advanced as a justification for unequal treatment based on territorial limitations. This trinity is: (1) the concept of "territoriality"; (2) the "balanced allocation of taxing powers"; (3) and the concept of "coherence".[142] My proposal is to abandon the first concept (*see* section 4.2.2.), narrow the second (*see* section 4.2.3.) and concentrate on the last, i.e. coherence (*see* section 4.2.4.).

4.2.2. Territoriality

It is easy to give short shrift to the concept of territoriality[143] as such in this context. Territoriality is not in itself a "public interest" that justifies unequal treatment in specific cross-border situations. It is merely a constraint to the taxing powers of a Member State. The use of the word as a technical term results in the problem to be resolved, but not in the solution. It is necessary to assess why and under what legal heading the limited territorial scope of a tax jurisdiction may result in the unequal treatment of domestic situations and cross-border situations.

Case Law IBFD and DE: ECJ, 17 Oct. 2013, Case C-181/12, *Yvon Welte v. Finanzamt Velbert* para. 49, ECJ Case Law IBFD.

136. Cordewener, *supra* n. 88, at p. 35 et seq. and p. 57 et seq. and N. Bammens, *The Principle of Non-Discrimination in International and European Tax Law* p. 571 et seq. (IBFD 2012).
137. Wattel (2004), *supra* n. 3, at p. 84 et seq.
138. DK: Opinion of Advocate General Kokott, 13 Mar. 2014, Case C-48/13, *Nordea Bank Danmark A/S v. Skatteministeriet* paras. 21-28, ECJ Case Law IBFD.
139. *CIBA* (C-96/08), at paras. 35-38.
140. *K* (C-322/11), at paras. 37-47; *AMID* (C-141/99), at para. 27; *X Holding* (C-337/08), at paras. 20-24; *Bouanich II* (C-375/12), at paras. 46-48; *Argenta Spaarbank* (C-350/11), at paras. 24-34; *Marks & Spencer* (C-446/03), at paras. 32-34; *A Oy* (C-123/11), at paras. 34 & 35; and *Lidl Belgium* (C-414/06), at paras. 18-26.
141. *Nordea Bank* (C-48/13), at para. 24.
142. Wattel, *supra* n. 75, at p. 144 et seq.
143. *See*, for example, *Futura Singer* (C-250/95), at paras. 18-22.

4.2.3. Balanced allocation of taxing powers

The "balanced allocation of taxing powers" has gained prominence in EU tax law since it was created by the ECJ in 2005.[144] Since then, it has evolved into a multi-faceted catch-all defence, which is employed to underscore both the emerging rise of domestic tax sovereignty and the attending compartmentalization of the Internal Market.[145]

Taking a closer look, this concept is only of limited value. It starts from the self-evident assumption that the Member States are free to allocate taxing rights between themselves on a personal or territorial basis. It then asserts that the result of such a balancing act must be recognized by taxpayers. As a result, the core element of this ground of justification is to prevent domestic and foreign taxpayers from allocating at liberty revenue and expenditure to the Member States involved.[146] The taxpayer cannot be hindered in freely transferring goods, services, capital and persons within the European Union. But the taxpayer cannot transfer the tax base at will between tax jurisdictions, thereby seeking to place profits in low-tax jurisdictions and losses in high-tax jurisdictions without underlying economic transactions. The jurisprudence of the ECJ with regard to the loss relief schemes applied in the United Kingdom,[147] Finland[148] and the Netherlands[149] addresses this challenge. In a similar vein, the ECJ's decisions on thin capitalization[150] and transfer pricing[151] reject the taxpayer's wish to manipulate profit allocation by way of intra-group dealings, which are not at arm's length.

While this is a defensible position, there is no reason to assume that the "balanced allocation of taxing powers" between two Member States increases the power of these Member States to tax cross-border flows of persons, assets and activities in a discriminatory fashion as assumed in *National Grid Indus*[152] or *Lidl Belgium* (Case C-414/06).[153] This would be to empower the Member States to contract at the expense of a third party, i.e. the taxpayer. The Member States must accept that both mandatory and voluntary constraints on worldwide taxation only reduce and do not enlarge taxing powers. Neither the unilateral waiver of taxing rights by one Member State nor the bilateral agreement on mutual waivers of taxing rights between the parties to a tax treaty give rise to a justification of building individual tax fortresses within the European Union. National tax legislation remains subject to full control under the fundamental freedoms.[154] If the options for the domestic legislator are geographically reduced, this cannot establish a carve-out with regard to the requirements of the Internal Market.

4.2.4. Coherence: the link between neutrality and territoriality

Coherence, on the other hand, is a meaningful concept, which can provide a useful connection between the demands of neutrality and the constraints of territoriality.[155] The protection of the cohesion of domestic tax legislation is in line with the principle of tax neutrality if insofar as it prevents taxpayers from cherry-picking, i.e. reaping tax benefits without shouldering the corresponding tax burden. This element has also been emphasized by the ECJ in recent judgements, for example, with regard to "symmetry" in the recognition of profits and losses.[156] While some of these judgements address this question in the context of the "balanced allocation of taxing powers",[157] "symmetry" is better characterized as an exemplification of "coherence".[158] It results in the question of whether or not the claims of the taxpayer go beyond the treatment that a resident taxpayer would enjoy in a purely domestic situation, i.e. the link between the advantage and the disadvantage of a tax provision.

Insofar, the concept of coherence can reconcile neutrality and territoriality in EU tax law. It takes account of the territorial limitations of a taxing right and asks the question as to whether or not the denial of a tax benefit is justified by the territorial exclusion of corresponding income. This test can be applied irrespective of the existence and the design of the tax system of any other Member State that is involved. We are not talking about once-off taxation here or any other interdependence between two or more tax systems. The coherence test is limited to a unilateral perspective on one tax system and asks whether the denial of a tax benefit is justified to avoid over-compensation for foreign taxpayers or cross-border transactions.

5. Source-Related Income and Expenditure

5.1. Allocation of expenditure

5.1.1. Direct link between taxable income and expenditure

A very good example for this approach can be found in the question of whether or not a taxpayer is entitled to claim a deduction for business expenditure incurred in respect of a certain domestic or foreign activity.[159] As a starting point,

144. *Marks & Spencer* (C-446/03), at paras. 45 & 46.
145. J. Englisch, *Aufteilung der Besteuerungsbefugnisse – Ein Rechtfertigungsgrund für die Einschränkung von EG-Grundfreiheiten* (IFSt 2008).
146. *Emerging Markets* (C-190/12), at para. 98; *Lidl Belgium* (C-414/06), at para. 32; *K* (C-322/11), at para. 51; *Société de Gestion Industrielle* (C-311/08), at paras. 60-62; *A Oy* (C-123/11), at paras. 41-43; *Nordea Bank* (C-48/13), at paras. 26-30; and AG Opinion in *Nordea Bank* (C-48/13), at para. 40. *See also* W. Schön, *Abuse of Rights and European Tax Law*, in *Comparative Perspectives on Revenue Law: Essays in Honour of John Tiley* p. 84 et seq. (J.F. Avery Jones, P. Harris & D. Oliver eds. Cambridge U. Press 2008).
147. *Marks & Spencer* (C-446/03), at para. 46.
148. FI: ECJ, 18 July 2007, Case C-231/05, *Oy AA* paras. 51-56, ECJ Case Law IBFD.
149. *X Holding* (C-337/08), at paras. 27-33.
150. UK: ECJ, 13 Mar. 2007, Case C-524/04, *Test Claimants in the Thin Cap Group Litigation v. Commissioners of Inland Revenue* para. 75, ECJ Case Law IBFD.
151. *Société de Gestion Industrielle* (C-311/08), at paras. 60-62.
152. *National Grid Indus* (C-371/10), at paras. 42-51.
153. *Lidl Belgium* (C-414/06), at paras. 32-34 & 52.
154. *Beker* (C-168/11), at paras. 33 & 34; *Argenta Spaarbank* (C-350/11), at paras. 50-52; *Avoir Fiscal* (270/83), at para. 26; and *Saint-Gobain* (C-307/97), at paras. 56 & 57.
155. Wattel (2004), *supra* n. 3, at p. 92 et seq.
156. Lang, *supra* n. 83, at p. 537 et seq.
157. *K* (C-322/11), at paras. 50-55; *Philips Electronics* (C-18/11), at paras. 23 & 24; and *Lidl Belgium* (C-414/06), at para. 33.
158. AG Opinion in *Nordea Bank* (C-48/13), at paras. 41 & 43.
159. Cordewener, *supra* n. 88, at p. 40 et seq.; K. van Raad, *Non-Residents – Personal Allowances, Deduction of Personal Expenses and Tax Rates*, 2 World Tax J. 2, sec. 2. (2010), Journals IBFD; Malherbe et al., *supra* n. 3, at p. 59 et seq.; and HJI Panayi, *supra* n. 17, at p. 207 et seq.

the ECJ has convincingly decided that each Member State, i.e. the residence Member State and the source Member State, must grant full deductibility for business expenditure that is directly linked to PEs and other sources of income present in their territory.[160] The same is true for similar costs, such as income-related service fees paid to tax advisors.[161]

In addition, the fact that the recipient of the expenditure is not taxable in the same Member State is irrelevant.[162] It is also even irrelevant if the counterparty resides in a low-tax jurisdiction, thereby reducing the overall tax burden on the transaction.[163] This core statement is particularly important, as it ensures unrestricted cross-border flow of goods, services and capital. Any tax incentive towards local suppliers of goods, services or capital would, therefore, be counter to the main purpose of the Internal Market.

On the other hand, no Member State must grant a deduction for business expenditure directly linked to foreign income that is not taxable in that Member State due to territorial constraints. "Income" as such is a synthetic concept, i.e. the net total of revenue and expenditure. Consequently, the cohesion of the tax system justifies this denial of deductibility. This is a clear case covered by the notion of "coherence" that enables a Member State to deny the deduction of expenditure if the corresponding income is not taxable likewise. A Member State's reliance on "coherence" is also not pre-empted by the instance that it has voluntarily limited its tax jurisdiction to its own territory. This is due to the fact that in the reverse situation the Member State in question equally cannot tax locally-sourced income derived by foreigners on a gross basis, thereby leaving the deductibility of business expenditure to the home Member State of the taxpayer. But it should be noted that a problem arises when the taxpayer requests the deduction of foreign business expenditure as far as it exceeds foreign business revenue, i.e. in a loss situation. We shall come to this situation at a later stage (*see* section 5.2.).

5.1.2. General business expenditure

With regard to general business expenses that have been incurred by a company, the ECJ has expressed the opinion that the source Member State does not have to take such expenses into account, as these are not linked specifically to its territory.[164] This gives the impression that only the residence Member State must grant relief for all business expenditure that cannot be allocated to a particular source or item of income. Yet this approach conflicts with the general assumption that EU law is indifferent with regard to allocation of taxing rights. The mere fact that two Member States have allocated between them the power to tax income deriving from a cross-border business means that these two Member States are equally responsible for granting relief for general business expenditure. This is supported by the fact that tax neutrality, in principle, requires the same treatment of foreign investment, such as domestic investment, as the treatment of foreign residents, such as domestic residents. As the taxpayer is, in a purely domestic situation, in the position to deduct general business expenditure, the same should be true for cross-border activities.

On the other hand, the fact remains that each of the Member States involved is only entitled to tax a fraction of that business income. This justifies, under the heading of "coherence", the practical option to grant to a taxpayer deductibility under a fractional approach. General business expenditure would then be allocated under a rational key, such as income or assets. This leads to complicated issues of calculation and compliance for the taxpayer, but is fully in line with the fact that the existence of several tax jurisdictions and the related "disparities" are covered by the tax sovereignty of Member States. Otherwise the residence Member State might fall victim to overstated expenditure, while source Member States restrict deductibility beyond legitimacy.

5.2. Cross-border loss compensation

The issue of cross-border loss compensation has been decided by the ECJ both with regard to source Member State legislation and with regard to legislation by residence Member States.[165] Foreign residents deriving income from a domestic source are, in general, not entitled under national legislation to set off positive source income against losses derived outside the territory of the source Member State. This was held to be compatible with the fundamental freedoms in the ECJ's 1997 judgement in *Futura Singer* (Case C-250/95), where the concept of territoriality was successfully invoked to deny comparability between residents and non-residents.[166] In a similar vein, the ECJ has stated in the various decisions based on *Marks & Spencer* that the residence Member State is not required to grant loss compensation with regard to foreign investments and activities if the jurisdiction to tax the corresponding profits lies exclusively with the source Member State, for example, if the exemption method applies or if the loss is derived by a self-standing subsidiary resident in the source Member State.[167] These statements affirm a strong version of the territoriality principle with regard to loss allocation.[168]

160. *Gerritse* (C-234/01), at para. 27; *Commission v. Finland* (C-342/10), at paras. 37-43; DE: ECJ, 15 Feb. 2007, Case C-345/04, *Centro Equestre da lezíria Grande Lda v. Bundesamt für Finanzen* para. 23, ECJ Case Law IBFD; and *Schröder* (C-450/09), at paras. 39-46.
161. *Conijn* (C-346/04), at paras. 16-25.
162. *Eurowings* (C-294/97), at para. 42; DK: ECJ, 28 Oct. 1999, Case C-55/98, *Skatteministeriet v. Bent Vestergaard* paras. 23 & 24, ECJ Case Law IBFD; and *Skandia Ramstedt* (C-422/01), at para. 51. *See also* FI: ECJ, 13 Nov. 2003, Case C-42/02, *Diana Elisabeth Lindman v. Skatterättelsenämde* para. 22, ECJ Case Law IBFD; IT: ECJ, 20 May 2010, Case C-56/09, *Emiliano Zanotti v. Agenzia delle Entrate – Ufficio Roma 2* paras. 36-44, ECJ Case Law IBFD; *SIAT* (C-318/10), at paras. 18-33; and *Tankreederei I* (C-287/10), at para. 26.
163. *Eurowings* (C-294/97), at para. 43; *Skandia-Ramstedt* (C-422/01), at para. 52; and *SIAT* (C-318/10), at paras. 38 & 39.
164. *Centro Equestre* (C-345/04), at para. 27. *See also* Monsenego *supra* n. 5, at p. 223 et seq. and p. 239 et seq.
165. For an overview, *see From Marks & Spencer to X Holding* (D. Weber and B. da Silva eds., Kluwer 2011); HJI Panayi, *supra* n. 17, at p. 182 et seq. and p. 214 et seq.; and Terra & Wattel, *supra* n. 1, at p. 551 et seq.
166. *Futura Singer* (C-250/95), at paras. 18-22.
167. *Marks & Spencer* (C-446/03), at paras. 41-51 and *Lidl Belgium* (C-414/06), at paras. 27-54.
168. S. van Thiel, *X Holding: A Denial of Justice*, in Weber & Da Silva eds., *supra* n. 165, at p. 51 et seq.

Nevertheless, the ECJ has been willing to change its stance if the taxpayer is not in the position to deduct the loss in the Member State that bears the primary responsibility. In *Lakebrink* (Case C-182/06)[169] and *Renneberg* (Case C-527/06),[170] the ECJ held that the source Member State must take account of foreign losses, i.e. those incurred in the residence Member State, if the taxpayer derives nearly all his income in the source Member State where he is subject to limited tax liability. And in *Marks & Spencer*[171] as well as in ensuing judgements, such as *Lidl Belgium*[172] and *A Oy* (Case C-123/11),[173] the ECJ required the residence Member State to grant relief if the taxpayer could not permanently use the losses in the source Member State. It has been said before[174] that this technique of making the availability of losses in one Member State dependent on the situation in the other Member State is incompatible with the principle of tax neutrality and the ongoing existence of double taxation and disparities. But what is the right solution? In three recent opinions, Advocate Generals Kokott[175] and Mengozzi[176] proposed disregarding tax neutrality and affirming territoriality. EU law, the Advocate Generals wrote, should never require any Member State to deduct losses if the corresponding profits arise outside its jurisdiction. It is, in their view, "only relevant to which activity and, therefore, to which taxing power a loss belongs".[177] It does not come as a surprise that Advocate General Kokott refers to the ECJ's judgement in *National Grid Indus* to support her view that there exists "a clear demarcation of the fiscal powers of the Member States".[178] In academic writing, the majority view[179] still seems to be that cross-border loss compensation should be available without any interdependence with the treatment in the "loss state" but mitigated by a "recapture" proviso.

What is the outcome if we test loss compensation against tax neutrality in a unilateral fashion, i.e. omitting the situation in the other Member State? First, this means that options for "double-dipping" are irrelevant. In the Advocate General's Opinion in *Oy AA* (Case C-231/05), Advocate General Kokott aptly stated that in a world where double taxation exists, double deductions are allowed to happen. But then she added the valuable insight that the taxpayer who enjoys double deduction of losses should not expect to be taxed on the corresponding profit only once.[180] Such a situation applies insofar as the concept of "coherence" demands that cross-border loss compensation is not a one-sided option for the taxpayer.[181] This was rightly stressed by the ECJ in *Krankenheim Ruhesitz am Wannsee* (Case C-157/07),[182] where the taxpayer unsuccessfully attacked the recapture of profits by the residence Member State after a preceding offset for foreign losses. The fact that the source Member State declined to award loss compensation did and should not matter at all.[183] In *Oy AA*, the ECJ also correctly denied the full deduction for a payment of a Finnish subsidiary to its Swedish parent company under the Finnish scheme for loss contributions, as the resulting profit would only appear in the foreign subsidiary's income, which was not taxable in Finland.[184]

The real problem is apparent if this line of thinking is taken further. That is, are the requirements of "coherence" fulfilled if cross-border loss compensation is mitigated by a recapture for ensuing profits? Or is the residence Member State entitled to insist on a notional set-off with untaxed profits preceding the current loss exposure before it must reduce the domestic tax burden? Or does "coherence" require that the Member State granting the loss relief is also fully entitled to tax any previous or successive profits that exceed the amount of recaptured losses? The vague notion of "symmetry", which the ECJ continuously refers to in its judgements on loss compensation, indicates an unresolved issue. That is, does the concept of coherence require symmetric tax treatment of all profits and losses arising from a single investment or arising from all activities in a given Member State? Such far-reaching demand would severely undermine the effect of the underlying tax treaties. Or does the symmetry of the individual loss and the individual recapture suffice? This result would confront the residence Member State with the full disadvantage, but only a limited portion of the advantage. A preliminary answer was recently given by the ECJ in *Nordea Bank*, where the Court referred to the full profit, including latent gains, generated by the foreign establishment before the business is closed or sold to a third party.[185]

The solution can be developed when we reconsider the concept of tax neutrality. The benchmark is the taxation of worldwide income without any territorial constraints. Under these circumstances, a taxpayer would be entitled to full loss compensation, as provided for by the legislation in the Member State in question. This leads to the conclusion that a taxpayer that is subject to territorially limited taxation is entitled to claim full loss compensation if he is willing to undergo full taxation of all profits arising from

169. LU: ECJ, 18 July 2007, Case C-182/06, *État du Grand-Duché de Luxembourg v. Hans Ulrich Lakebrink, Katrin Peters-Lakebrink* paras. 14-31, ECJ Case Law IBFD.
170. *Renneberg* (C-527/06), at paras. 59-71.
171. *Marks & Spencer* (C-446/03), at paras. 53-56.
172. *Lidl Belgium* (C-414/06), at para. 47.
173. *A Oy* (C-123/11), at paras. 47-49.
174. Lang, *supra* n. 83, at p. 535 et seq.
175. FI: Opinion of Advocate General Kokott, 19 July 2012, Case C-123/11, *Veronsaajien oikeudenvalvontayksikkö and Valtiovarainministeriö v. A Oy* paras. 47-54, ECJ Case Law IBFD and UK: Opinion of Advocate General Kokott, 23 Oct. 2014, Case C-172/13, *European Commission v. United Kingdom of Great Britain and Northern Ireland* paras. 36-53, ECJ Case Law IBFD.
176. FI: Opinion of Advocate General Mengozzi, 31 Mar. 2013, Case C-322/11, *K* paras. 58-91.
177. AG Opinion in *A Oy* (C-123/11), at para. 50.
178. AG Opinion in *Commission v. United Kingdom* (C-172/13), at para. 51.
179. I. Richelle, *Cross-Border Loss Compensation: State and Critique of the Judicature,* in Richelle, Schön & Traversa eds., *supra* n. 30, at p. 101; Lang *supra* n. 83, at p. 538 et seq.; W. Schön, *Losing out at the Snooker Table: Cross-Border Loss Compensation for PEs and the Fundamental Freedoms,* in Hinnekens & Hinnekens eds., *supra* n. 3, at p. 813; and Van Thiel, *supra* n. 168, at p. 51.
180. FI: Opinion of Advocate General Kokott, 12 Sept. 2006, Case C-231/05 *Oy AA* para. 54 et seq., ECJ Case Law IBFD. *See also* UK: Opinion of Advocate General Geelhoed, 23 Feb. 2006, Case C-374/04, *Test Claimants in Class IV of the ACT Group Litigation v. Commissioners of Inland Revenue* para. 65, ECJ Case Law IBFD. *See again* Schön *supra* n. 179, at p. 823 et seq.
181. *K* (C-322/11), at paras. 64-71.
182. *Krankenheim Ruhesitz am Wannsee* (C-157/07), at paras. 40-45.
183. Id., at paras. 46-50.
184. *Oy AA* (C-231/05), at para. 56.
185. *Nordea Bank* (C-48/13), at paras. 32, 33 & 63.

the particular activity or investment.[186] In other words, a taxpayer who demands cross-border loss compensation must be entitled to waive the benefits of the exemption method and to switch to full taxation of corresponding foreign-source income. This includes the taxability of the "upside" of the foreign investment even if it exceeds the incurred losses, just like in the domestic case.

On the other hand, the taxpayer should be entitled to a foreign tax credit, as the Member States involved have agreed to do away with double taxation.[187] A taxpayer waiving its protection under the exemption method should at least enjoy the combination of worldwide income taxation and foreign tax credit under the credit method. This is, in my view, the lasting effect of the concept of "macro-coherence" as evolved in the line of jurisprudence initiated by *Wielockx*.

5.3. Intra-group profit allocation

In several judgements, the ECJ had to decide whether or not, and to what extent, the Member States are in the position to put a specific tax burden on cross-border intra-group dealings. The two most relevant examples are rules restricting the deductibility of interest payments on debt between affiliated companies and adjustments to transfer pricing under the arm's length standard. In both situations, the Member States reveal a tendency to be more generous with profit transfers between domestic affiliates, as the overall profit of the group is taxed domestically anyway. In early decisions, such as *Lankhorst-Hohorst* (Case C-324/00),[188] the ECJ rejected the claim of the Member States to ensure the "one-time taxation" of business profits arising within their territory. In later judgements, such as *Test Claimants in the Thin Cap Group Litigation* (Case C-524/04), *Lankhorst-Hohorst*[189] and *Société de Gestion Industrielle* (Case C-311/08),[190] the ECJ invoked the concept of the balanced allocation of taxing powers and attempts to counter tax avoidance to justify special measures taken by Member States against cross-border profit shifting. This sounds like an increased weight for the territorial aspects of taxation, which would not be in line with the purpose of the Internal Market to foster the activities of international corporate groups in the European Union.

Ultimately, the ECJ managed to reconcile the concept of tax neutrality and that of territoriality by recurring to the underlying purpose of the fundamental freedoms.[191] These are meant to support the efficient allocation of resources in the European Union and, therefore, require the neutral treatment of domestic and cross-border flows of goods, services, capital and persons. They do not support transactions that do not reflect the outcome of market forces in an area of free competition. If, and so far as, the conditions for intra-group dealings deviate from dealings between independent market participants, the underlying contracts are presumed to constitute abusive "artificial arrangements". The option for taxpayers to allocate taxable income to the involved countries at will is also not in line with the legitimate core of the protection of the balanced allocation of taxing powers. Specific adjustments for non-arm's length transactions under national legislation are, therefore, justified. But this rationale also delineates the limits to the application of the arm's length standard. If the companies involved can demonstrate that a non-arm's length transaction fulfils a genuine business purpose within the enterprise, the Member States cannot make adjustments just to protect their territorial taxing rights.

5.4. Tax incentives

A major problem for the Internal Market is the introduction of tax incentives, as these incentives are frequently used to improve the situation of domestic business or other domestic activities. As a matter of principle, the ECJ does not prevent the Member States from introducing tax incentives, as this is an expression of their tax sovereignty, which is only limited by the EU Treaty provisions on State aid.[192] But the ECJ would never accept any territorial limitation to tax incentives that would result in preferential treatment of domestic commercial activities.[193] This has been expressed in cases like *Société Baxter* (Case C-254/97),[194] *Laboratoires Fournier* (Case C-39/04)[195] and *Commission v. Spain* (Case C-248/06),[196] where the ECJ invalidated provisions that were intended to restrict preferential treatment of expenditure for research and development (R&D) to activities performed in the relevant Member State's territory. This is also true for tax incentives in the private sector as the recent judgement on Germany's tax subsidies for owner-occupied houses reveals[197] or benefits for investment by domestic business.[198] The only area where the ECJ

186. This would not only be relevant for the state of residence but also for the source Member State, in situations like *Futura Singer* (C-250/95), *Lakebrink* (C-182/06), and *Renneberg* (C-527/06), where the taxpayer demanded to reduce the positive tax base in the source Member State by negative income in the residence Member State or in a third state. *See* Schön, *supra* n. 179, at p. 826 et seq. Critical, *see* Monsenego, *supra* n. 5, at p. 251 et seq.
187. This matter has been left open in the AG Opinion in *Nordea Bank* (C-48/13), at para. 55.
188. *Lankhorst-Hohorst* (C-324/00), at paras. 19 & 42. *See also* A. Cordewener, *Company Taxation, Cross-Border Financing and Thin Capitalization in the EU Internal Market: Some Comments on* Lankhorst-Hohorst GmbH, 43 Eur. Taxn. 4 (2003), Journals IBFD.
189. *Thin Cap* (C-524/04), at paras. 71-92 and BE: ECJ, 17 Jan. 2008, Case C-105/07, *NV Lammers & Van Cleeff v. Belgische Staat* paras. 26-30, ECJ Case Law IBFD.
190. *Société de Gestion Industrielle* (C-311/08), at paras. 56-69 and *Itelcar* (C-282/12), at paras. 37-38. *See also* J. Englisch, *Einige Schlussfolgerungen zur Grundfreiheitskompatibilität des § 1 AStG – zugleich Anmerkung zum Urteil des EuGH in der Rs.SGI*, 19 Internationales Steuerrecht 4, p. 139 (2010) and M. Glahe, *Transfer Pricing and EU Fundamental Freedoms*, 22 EC Tax Rev. 5, p. 222 (2013).
191. W. Schön, *Transfer Pricing, the Arm's Length Standard and European Union Law*, in Richelle, Schön & Traversa eds., *supra* n. 30, at p. 73 et seq.
192. Malherbe et al. *supra* n. 3, at p. 120.
193. Graetz & Warren (2006), *supra* n. 3, at p. 1212 et seq.
194. FR: ECJ, 8 July 1999, Case C-254/97, *Société Baxter, B. Braun Médical SA, Société Fresenius France and Laboratoires Bristol-Myers-Squibb SA v. Premier Ministre, Ministère du Travail et des Affaires sociales, Ministère de l'Economie et des Finances and Ministère de l'Agriculture, de la Pêche et de l'Alimentation* paras. 10-14, ECJ Case Law IBFD.
195. *Laboratoires Fournier* (C-39/04), at paras. 17 & 18.
196. ES: ECJ, 13 Mar. 2008, Case C-248/06, *Commission of the European Communities v. Kingdom of Spain* paras. 20-25, ECJ Case Law IBFD.
197. *Commission v. Germany* (C-152/05), at paras. 19-31.
198. *Jobra* (C-330/07), at para. 33 and *Tankreederei I* (C-287/10), at paras. 21-25.

has explicitly accepted the power of the Member States to restrict tax benefits to territorially defined purposes is the non-profit sector as the sovereignty of Member States in matters of culture and similar charitable purposes is guaranteed by the EU Treaties.[199] This line of reasoning was recently extended to gift tax incentives furthering "social objectives"[200] that might make activities and assets outside the national borders not comparable to activities and assets inside the national territory, in particular, the protection of national heritage buildings.[201]

While this is fully in line with the fundamentals of the Internal Market,[202] the borderline cases refer to the situation where a taxpayer claims tax incentives for assets or items of income, which are themselves not taxable in the Member State due to territorial constraints. The recent decision of the ECJ on the deductibility of notional interest on equity in *Argenta Spaarbank* (Case C-350/11) is an example of this. In order to achieve equal treatment of debt and equity and thereby to reduce the tax burden on equity, Belgium had introduced a deduction for notional interest on equity capital, i.e. an allowance for corporate equity. Under this, capital invested in foreign branches that are exempt under tax treaties would not qualify for this notional interest deduction. Surprisingly, the ECJ held this to be an infringement of the freedom of establishment. The Court could not perceive a "direct link" between the fact that the income generated by the foreign investment is tax exempt and the deduction of a notional return on the capital employed.[203] They referred to the fact that the allowance for corporate equity also applies in years where there is no positive return on the investment. This is puzzling, as "symmetry" should not be restricted to the outcome of a single tax year, but rather to the *ex ante* perspective of the taxpayer and the tax authorities. Any "real" interest payments on debt capital, which is invested in a foreign branch, is also clearly not deductible at the level of the headquarters. This should lead to the acknowledgement that, as a matter of coherence, the tax exemption for foreign income should result in the non-deductibility of directly linked foreign expenditure, whether notional or not. The fact that the other state involved does not provide for similar treatment should be irrelevant. This is contrary to Advocate General Mengozzi's assumption that only in the case of coordinated action could the "balanced allocation of taxing powers" justify the reduced approach taken by Belgium.[204]

6. Cross-Border Imputation of Corporate Income Tax

6.1. Tax credits

A line of judgements where the ECJ's judicature is also not in line with the major requirements set out in section 2. is the jurisprudence of the Court in respect of the cross-border imputation of the corporate income tax.[205] In *Manninen* (Case C-319/02), the ECJ held that the residence state must, under the fundamental freedoms, grant a credit for foreign corporate income tax in the same way as for domestic corporate income tax.[206] In her arguments, Advocate General Kokott explicitly linked this obligation to the right of the source Member State to tax income derived in its territory.[207] The ECJ found no infringement on the coherence of corporate income tax integration under domestic law, as the Member States could easily extend their domestic benefits to foreign dividends.[208] The same result could be realized in the reverse situation, i.e. when foreign shareholders demanded in *Burda* (Case C-284/06) to be given a tax credit from the source Member State under the same conditions as resident shareholders, the ECJ repeated its view that the source Member State enjoys the substantive right to tax companies located on its territory, thereby justifying the denial of cross-border imputation to foreign shareholders.[209]

199. DE: ECJ, 14 Sept. 2006, Case C-386/04, *Centro de Musicologia Walter Stauffer v. Finanzamt München für Körperschaften* para. 39, ECJ Case Law IBFD; DE: ECJ, 27 Jan. 2009, Case C-318/07, *Hein Persche v. Finanzamt Lüdenscheid* paras. 43 & 44; ECJ Case Law IBFD; BE: ECJ, 10 Feb. 2011, Case C-25/10, *Missionswerk Werner Heukelbach eV v. État Belge* para. 30; and AT: ECJ, 16 June 2011, Case C-10/10, *European Commission v. Republic of Austria* para. 33, ECJ Case Law IBFD.
200. NL: Opinion of Advocate General Kokott, 2 Oct. 2014, Case C-133/13, *Staatssecretaris van Economische Zaken, Staatssecretaris van Financiën v. Q* paras. 40-41.
201. NL: ECJ, 18 Dec. 2014, Case C-87/13, *Staatssecretaris van Financiën v. X* paras. 27-34, ECJ Case Law IBFD and NL: ECJ, 18 Dec. 2014, Case C-133/13, *Staatssecretaris van Economische Zaken, Staatssecretaris van Financiën v. Q* paras. 22-29, ECJ Case Law IBFD.
202. For a recent defence of territorially limited tax incentives under the auspices of "coherence", *see* E. Traversa & B. Vintras, *The Territoriality of Tax Incentives within the Single Market*, in Richelle, Schön & Traversa eds., *supra* n. 30, at p. 171 and E. Traversa, *Tax Incentives and Territoriality within the European Union: Balancing the Internal Market with the Tax Sovereignty of Member States*, 6 World Tax J. 3 (2014), Journals IBFD.
203. *Argenta Spaarbank* (C-350/11), at paras. 46-49. For a critical assessment, *see* Traversa, *supra* n. 202, at secs. 3.2. & 6. and R. Nyt & S. Peeters, *Balanced Allocation and Coherence: Some Thoughts in the Light of Argenta and K*, 23 EC Tax Rev. 2, p. 67 et seq. (2014).
204. BE: Opinion of Advocate General Mengozzi, 19 Sep. 2012, Case C-350/11, *Argenta Spaarbank NV v. Belgische Staat* para. 65, ECJ Case Law IBFD.
205. Graetz & Warren (2007), *supra* n. 3, at p. 1595 et seq.; HJI Panayi, *supra* n. 17 at p. 235 et seq.; W. Schön, *La Taxation Transfrontalière de Dividendes*, in *Liber Amicorum Jacques Malherbe* p. 953 (Bruylant 2006); P.J. Wattel, *Taxation of Intercompany Dividends and EU Law: Three Surprising Aspects of the Recent Case Law of the European Court* in Maisto ed., *supra* n. 37, at p. 39; and Englisch *supra* n. 132, at p. 197.
206. *Manninen* (C-319/02), at paras. 20-54. *See also Lenz* (C-315/02), at paras. 31 & 32; *ACT Group Litigation* (C-374/04), at para. 55; *Kronos* (C-47/12), at para. 65; *Test Claimants in the FII Group Litigation* (C-446/04), at paras. 46-51, ECJ Case Law IBFD; *Meilicke II* (C-292/04), paras. 20-24, ECJ Case Law IBFD; AT: ECJ, 10 Feb. 2011 Joined Cases C-436/08 and C-437/08, *Haribo Lakritzen Hans Riegel BetriebsgmbH, Österreichische Salinen AG v. Finanzamt Linz* paras. 46-172, ECJ Case Law IBFD; DE: ECJ, 30 June 2011, Case C-262/09, *Wienand Meilicke, Heidi Christa Weyde and Marina Stöffler v. Finanzamt Bonn-Innenstadt* paras. 24-34, ECJ Case Law IBFD; and UK: ECJ, 13 Nov. 2012, Case C-35/11, *Test Claimants in the FII Group Litigation v. Commissioners of Inland Revenue, Commissioners for her Majesty's Revenue & Customs* paras. 36-65, ECJ Case Law IBFD.
207. NL: Opinion of Advocate General Kokott, 18 Mar. 2004 Case C-314/02, *Commission of the European Communities v. Kingdom of the Netherlands*, para. 71, who stated: "[h]ence the tax revenues ultimately remain in the State in which entrepreneurial activity is undertaken to generate profits". For a concurring view, *see* J. Hey, *Vorrecht des Quellenstaates und binnenmarktkonforme Besteuerung von Kapitalgesellschaften in der Europäischen Union*, in *Steuerzentrierte Rechtsberatung: Festschrift für Harald Schaumburg zum 65. Geburtstag* p. 767 (W. Spindler, K. Tipke & T. Rödder eds., Otto Schmidt 2009).
208. *Lenz* (C-315/02), at paras. 37 & 38; *Manninen* (C-319/02), at paras. 45 & 46; and *Meilicke* C-292/04), at paras. 28 & 29.
209. DE: ECJ, 26 June 2008, Case C-284/06, *Burda Verlagsbeteiligungen GmbH v. Finanzamt Hamburg-Am Tierpark* paras. 83-88, ECJ Case Law IBFD; *ACT Group Litigation* (C-374/04), at paras. 57, 59 & 60; and DE: ECJ, 17 Sept. 2009, Case C-182/08, *Glaxo Wellcome GmbH & Co. KG v. Finanzamt München II* paras. 61-70, ECJ Case Law IBFD.

Strangely enough, the ECJ adopted the opposite path in its judgements on withholding taxes on dividends,[210] thereby "departing from internationally accepted standards".[211] While the ECJ did not require residence Member States to grant a credit unilaterally for foreign withholding taxes on dividend and interest payments, even if they granted this credit for domestic withholding taxes,[212] the Court required the source Member State to extend a tax exemption on domestic intercorporate dividends to intercorporate dividends received by foreign corporations.[213] The ECJ rejected the argument advanced by Member States, in particular by Germany, that the withholding taxation on outbound dividends was required to ensure the coherence of the domestic tax system and the allocation of taxing powers between the Member States.

This different attitude of the ECJ towards corporate income tax imputation, on the one hand, and withholding taxation, on the other, has been criticized widely in academic writing, as giving rise to the question of whether or not and why the Court consciously and systematically distinguishes between economic double taxation, which appears to be forbidden, and juridical double taxation, which appears to be allowed.[214] On closer examination, one has to accept the fact that the ECJ went too far in its *Manninen* line of jurisprudence on cross-border imputation by making the following two wrong statements:

(1) The ECJ did not take note of the fact that the cross-border imputation for the underlying corporate income tax is linked to the problem of double taxation in general.[215] The concept of tax neutrality that requires domestic tax laws to be judged on a stand-alone basis results in the conclusion that the Member States cannot be forced to take into account taxes paid to foreign jurisdictions. There is no prohibition not to discriminate against foreign tax. This is also true for underlying corporate income tax.

(2) The ECJ created implicitly an order of priority with regard to the taxation of corporate profits. The tax on the corporate profit belongs to the source Member State and the tax on the dividend belongs to the residence Member State.[216] Only if the source Member State grants relief for underlying corporate income tax is the residence Member State redeemed from its obligations.[217] While this allocation of taxing rights is clearly a defensible policy for domestic legislation, bilateral tax treaties or even EU directives, it is by no means required by the concept of the Internal Market as set out in the provisions on the fundamental freedoms.[218] It suffices to note that the Commission's 1975 proposal on cross-border taxation of corporate profits only provided for a 50% imputation at the level of the foreign shareholder.[219]

There is one element in the *Manninen* strand of jurisprudence that indicates that the ECJ has mixed feelings regarding its own judicature on imputation systems. In several recent judgements, most prominently in *Haribo* (Joined Cases C-437/08 and C-438/08)[220] and most recently in *Kronos*,[221] the ECJ has reduced the obligation of the residence Member State to grant credit for foreign corporate income tax to the amount of income tax payable on the dividend under domestic law. With regard to the imputation of domestic corporate income tax, this limitation does not exist, which is particularly relevant if the recipient is in an overall loss situation. This court-made limitation to the foreign tax credit can be read as mitigation of the damage done by the ECJ in the first place when the Court mandated the residence Member State to grant a credit for a tax the revenue in respect of which belongs to a foreign jurisdiction. Only insofar as a foreign subsidiary has paid domestic corporate income tax, for example, with regard to a local PE in the Member State of the shareholder, would the residence Member State of the shareholder have to grant an imputation credit.

6.2. Exempt dividends and corresponding deductions

Treating foreign corporate income tax like domestic corporate income tax in *Bosal* (Case C-168/01) and *Keller Holding* (Case C-471/04), the ECJ required the Member States to treat stewardship costs and financing costs incurred at the level of the parent company with regard to domestic and foreign subsidiaries in the same fashion.[222] The ECJ has accepted that, under article 4(3) of the Parent-Subsidiary Directive (435/90), the Member States are free to decide whether or not and to what extent they recognize deductions for stewardship and financing. However, the ECJ has held that the Member States cannot sustain that there exists a "direct link" between the deductibility of those expenses and the payments of corporate income tax to another jurisdiction.[223] This result has been welcomed,

210. Graetz & Warren (2007), *supra* n. 3, at p. 1595 et seq. & p. 1612 et seq.
211. Malherbe et al., *supra* n. 3, at p. 133.
212. *Orange Europe Smallcap Fund* (C-194/06), at paras. 38-49; *Haribo* (Joined Cases C-436/08 and C-437/08), , at paras. 84-90; *Meilicke II* (C-262/09), at paras. 29 & 30; and *Franked Investment Income II* (C-35/11), at paras. 37-39.
213. *Denkavit Internationaal* (C-170/05), at paras. 34-36; *Amurta* (C-379/05), at para. 39; NL: ECJ, 11 June 2009, Case C-521/07, *Commission of the European Communities v. Kingdom of the Netherlands* paras. 32-51, ECJ Case Law IBFD; *Commission v. Italy* (C-540/07), at paras. 28-76; *Commission v. Spain* (C-487/08), at paras. 37-69; FR: ECJ, 15 Sept. 2011, Case C-310/09, *Ministre du Budget, des Comptes publics et de la Fonction publique v. Accor SA* paras. 39-63, ECJ Case Law IBFD; PT: ECJ, 6 Oct. 2011, Case C-493/09, *European Commission v. Portuguese Republic* paras. 28-51, ECJ Case Law IBFD; *Commission v. Germany* (C-284/09), at paras. 44-93; and *Commission v. Belgium* (C-387/11), at paras. 33-87.
214. Gammie, *supra* n. 49, at p. 172 et seq.; Vanistendael, *supra* n. 21, at p. 182 et seq.; Englisch, *supra* n. 132, at p. 205; and M. Lang, *ECJ Case Law on Cross-Border Dividend Taxation – Recent Developments,* 17 EC Tax Rev. 2, p. 69 et seq. (2008).
215. W. Schön, *Europäische Kapitalverkehrsfreiheit und nationales Steuerrecht*, in *Gedächtnisschrift für Brigitte Knobbe-Keuk* pp. 774-776 (W. Schön et al. eds., Otto Schmidt 1997); Graetz & Warren, *supra* n. 3, at p. 1609 et seq.; and Weber, *supra* n. 3, at p. 597 et seq.
216. *ACT Group Litigation* (C-374/04) at paras. 57, 59 & 60. *See also* Van Thiel, *supra* n. 21, at p. 164 et seq.
217. *Manninen* (C-319/02), at para. 34.
218. Graetz & Warren (2007) *supra* n. 3, at p. 1608 & p. 1619 et seq. and Englisch *supra* n. 132, at p. 214 et seq.
219. HJI Panayi, *supra* n. 17, at p. 14 et seq.
220. *Haribo* (Joined Cases C-437/08 and C-438/08), at paras. 86-90.
221. *Kronos* (C-47/12), at paras. 83-86.
222. Malherbe et al., *supra* n. 3, at p. 111 et seq.
223. *Bosal* (C-168/01), at paras. 40 & 41 and *Keller-Holding* (C-471/04), at para. 43. For a critical assessment, *see* D. Weber, *The* Bosal Holding *Case: Analysis and Critique*, 12 EC Tax Rev. 4, p. 220 (2003). In the AG Opinion in *ACT*

as it supports "one-time" deduction of business costs from an "overall perspective".[224]

A unilateral test of tax neutrality would, however, clearly disregard any foreign corporate income tax and ask whether or not domestic subsidiaries and foreign subsidiaries are in a comparable situation. This is generally not the case with regard to taxation in the Member State of the parent company and, therefore, the residence Member State of the parent company should be entitled to disallow the deductibility of business expenditure incurred in respect of foreign shareholdings, unless the foreign subsidiary pays dividends out of profits subject to corporate income tax in the parent company's jurisdiction.[225] The proposition advanced previously in this section. to the effect that the EU freedoms do not enforce "one-time deduction" of private or business expenditure "somewhere" supports the outcome of this analysis.

7. Personal Circumstances and Deductions

7.1. The state of the jurisprudence

The final subject to be addressed in this article concerns the recognition of personal circumstances and deductions in the ECJ's judicature, which has unfolded since *Schumacker* was delivered in 1995.[226] In these cases, the ECJ has taken the position that foreign and domestic residents are not in a comparable situation, as the domestic resident is subject to worldwide income taxation. The Member State would also be better equipped to access the information necessary to grant tax benefits with regard to personal circumstances. Only if the foreign taxpayer derives (nearly) all his income from the source Member State should the responsibility for personal deductions lie with this jurisdiction.

This jurisprudence has been widely criticized by academic writers.[227] The ECJ's analysis runs counter to several principles of EU tax law, for example, the concept that double taxation does not infringe on the fundamental freedoms and the assumption that EU law does not allocate specific responsibilities to the Member States. It results in contradictory outcomes when the Member States do not apply the exemption method but the credit method to out-of-Member State income.[228] In practice, given the existence of disparities, this doctrine does not work well if the residence Member State and the source Member State apply different policies with regard to families, for example, the resident Member State grants direct monetary benefits to resident couples and the source Member State grants income tax deductions.[229] This situation was nicely exploited by a German-Belgian couple recently in *Imfeld and Garcet*,[230] when the German husband and the Belgian wife persuaded the ECJ to allow family deductions for their joint children in Belgium on the wife's income, although the husband already benefitted in Germany from the legislation on foreign residents that was introduced following *Schumacker*.

An even stranger example is *Wallentin* (Case C-169/03), where the ECJ decided that Sweden had to extend the tax-free basic allowance under Swedish law to a foreign student who earned part-time wages in Sweden and received maintenance payments from his German parents.[231] Maintenance payments for children are not taxable under German law and, therefore, the ECJ held that Sweden had to make up for the non-availability of a basic allowance in Germany. It seems arbitrary that the ECJ would have decided otherwise if German law treated the maintenance payments as taxable in the first place and reduced the tax burden to zero by applying a basic allowance at the next level.

7.2. The fractional approach

The most sensible solution for these issues was proposed long ago. This is the "fractional approach".[232] Going back to the concept of territoriality, one should not try to mandate primary or secondary responsibilities for the taxation of cross-border income and any deductions and allowances to the Member States involved. Rather, one should start from the mere fact that the overall income of the taxpayer is taxed according to the allocation rules set out under international and national law. The assumption of the ECJ that the larger part of the income is in the majority of cases concentrated in the residence Member State[233] is not useful when it comes to many borderline situations. While source Member States always exercise a limited jurisdiction with regard to the worldwide income of a foreign resident, the residence Member State either applies the credit method or exempts some foreign income. It is, therefore, possible to calculate according to the laws of each Member State as to whether or not that Member State is going to tax the full income or only part of that income. In order to reach this result, one does not even have to take a look at the measurement and treatment of the income in any other Member State. The notion of "coherence" justifies in a straightforward way any reduction in the availability of allowances and deductions in relation to the amount of income derived under the relevant tax jurisdiction. That is all.

Group Litigation (C-374/04), at paras. 62-64, Advocate General Geelhoed expressed strong disagreement with the outcome and reasoning of *Bosal* (C-168/01). This position has not been shared by Wathelet, *supra* n. 120, at p. 906 et seq.

224. Kemmeren, *supra* n. 63, at p. 579.
225. Kingston, *supra* n. 3, at p. 300 et seq.; Wattel (2004), *supra* n. 3, at p. 89 et seq.; and Weber, *supra* n. 3, at p. 595.
226. *Schumacker* (C-279/93), at paras. 36-38; *Gerritse* (C-234/01), at paras. 47 & 48; and *Beker* (C-168/11), at paras. 43, 44 & 56.
227. Cordewener, *supra* n. 25, at p. 62; M. Lang, *Ist die Schumacker-Rechtsprechung am Ende?*, 51 Recht der Internationalen Wirtschaft 5, p. 336 et seq. (2005) and (2009), *supra* n. 3, at p. 101 et seq.; Vanistendael, *supra* n. 25, at p. 132; P.J. Wattel, *Progressive Taxation of Non-Residents and Intra-EC Allocation of Personal Tax Allowances: Why* Schumacker, Asscher, Gilly *and* Gschwind *do not suffice*, 40 Eur. Taxn. 6 (2000), Journals IBFD; and Weber, *supra* n. 3, at p. 603 et seq.
228. J.F. Avery Jones, *Carry on Discriminating*, 36 European Taxation 2 (p. 46 (1996).
229. Schön, *supra* n. 77, at p. 121.
230. *Imfeld and Garcet* (C-303/12), at paras. 56-63.
231. *Wallentin* (C-169/03), at paras. 3 & 21. *See also Meindl* (C-329/05), at para. 29; and EE: ECJ, 10 May 2012, Case C-39/10, *European Commission v. Republic of Estonia* para. 53, ECJ Case Law IBFD.
232. Van Raad, *supra* n. 159, at p. 154 et seq.; Cordewener, *supra* n. 77, at p. 66 et seq.; Kemmeren *supra* n. 12, at p. 173; and Wattel (2008), *supra* n. 3, at p. 214 et seq. & p. 222 et seq.
233. *Schumacker* (C-279/93), at paras. 32-34.

Nevertheless, the ECJ has so far rejected the "fractional approach" if applied in a unilateral fashion.[234] In *De Groot* (Case C-385/00), the ECJ held that the residence Member State cannot apply the "fractional approach" with regard to exempt foreign income, unless the relevant source Member States have enacted legislation to take care of the relevant private circumstances in a meaningful fashion.[235] This involves a concept of primary responsibility lying with the residence Member State, which does not have a basis in EU law. In *Beker* (Case C-168/11), the ECJ recently extended this line of reasoning to the way in which the residence Member State defines the foreign income available for the foreign tax credit.[236] The internal contradictions of this latest line of reasoning become obvious when we recognize that the principles of the Internal Market evidently do not require the Member States to grant a foreign tax credit at all. Can it be true that a Member State, which voluntarily grants a foreign tax credit, should have to take full coverage of personal circumstances in its specific design? The answer is no.

7.3. Progressive taxation

The most critical point where territorial taxation and worldwide tax jurisdiction seem to part ways at last is the application of a progressive tax rate. Should taxpayers be entitled to enjoy the full benefits of a progressive scale of tax rates, including tax-free thresholds and low-income tax brackets in each jurisdiction where they derive items of income? This might lead to a situation where the partitioning of investments and activities between several jurisdictions would result in a cumulative tax burden that is lower than the tax arising from full taxation of the comprehensive income in any of the Member States involved. This very much looks like a "free ride", which goes beyond the demands of tax neutrality.[237] The ECJ has recognized the problem, but went for a half-baked solution when it held in *Asscher* (Case C-107/97) that taxpayers are entitled to benefit from basic allowances and low income tax brackets in source Member States as long as there exists progressive taxation in the residence Member State.[238] This statement is only true if the residence Member State applies worldwide income taxation under the credit method. It is not true if the residence Member State exempts foreign income under bilateral tax treaties or unilateral legislation.[239] Even exemption with progression only results in the full taxation of the resident's remaining domestic income and does not remove the benefits enjoyed by income partitioning in the source Member States. Again, the ECJ's assumption that the residence Member State "takes care" of the overall taxation of individual income conflicts with the territorial allocation of taxing rights between the involved jurisdictions.

What is the right solution? First, it does not make sense to look for "once-only" allocation of benefits with regard to the tax rate. This would require the harmonization of tax legislation of the Member States that went beyond the demands of unilateral tax neutrality. On the other hand, the ultimate objective of tax neutrality is the equal treatment of all forms of cross-border and domestic flows of economic factors. The benchmark is again full taxation of worldwide income within each of the Member States involved. This would result in the unrestricted application of the progressive tax scale in each of the jurisdictions involved, i.e. the source Member States and the residence Member State. As the taxpayer would rely on the exemption of some parts of that income on a territorial basis, he would have to accept that he could only benefit from the lower tax brackets, including a tax-free basic allowance, on a fractional basis. This could be decided without any reference to the tax legislation in the other Member States involved. In each Member State, the taxpayer would be entitled to submit the numbers representing his full income, as measured under the rules of that Member State, so as to have the tax authorities calculate the (fictitious) overall tax burden on that income. This overall tax burden would then be broken down to the share of income taxable in that Member State given the territorial constraints under national and international law. In a way, this would imply an "exemption with progression" method for the tax treatment in the source Member State as well and not only for the residence Member State.

This measure would make treatment in each Member State coherent, but independent from the shape of the tax scale in the other Member States involved. Nevertheless, it could give rise to practical issues with regard to compliance and administrative overload. If the Member States, in particular the source Member States, wished a simple solution for themselves and for the taxpayers, they could easily opt for an elective tax system. Under this, taxpayers would either be treated under a special tax scale for foreign residents or they would be entitled to opt for treatment under an "exemption with progression" schedule.[240]

234. For a reduced basic allowance in the case of non-resident inheritance taxation, *see* DE: ECJ, 22 Apr. 2010, Case C-510/08, *Vera Mattner v. Finanzamt Velbert* paras. 24-38, ECJ Case Law IBFD and *Welte* (C-181/12), at paras. 58-61.
235. *De Groot* (C-385/00), at paras. 85-95 and *Imfeld and Garcet* (C-303/12), at para. 69.
236. *Beker* (C-168/11), at paras. 36-53, 59 & 60. For the application of the "fractional approach" in a credit method situation, *see* J.F. Avery Jones, *A Comment on "Progressive Taxation of Non-Residents and Intra-EC Allocation of Personal Tax Allowances"*, 40 Eur. Taxn. 8 (2000), Journals IBFD.
237. For a different view *see Biehl* (175/88), at paras. 15 & 16.
238. *Asscher* (C-107/97), at paras. 46-49; *Gerritse* (C-234/01), at paras. 52-54; and *Commission v. Spain* (C-562/07), at para. 54.
239. Cordewener, *supra* n. 77, at p. 44 et seq.
240. Terra & Wattel, *supra* n. 1, at p. 534 et seq. According to NL: ECJ, 18 Mar. 2010, Case C-440/08, *F. Gielen v. Staatssecretaris van Financiën* paras. 49-55, ECJ Case Law IBFD, the election to be treated as a resident can be a helpful auxiliary measure to rectify infringements of the fundamental freedom, but does not relieve the Member States from adjusting the specific provisions that conflict with the Internal Market.

8. Conclusions and Outlook

The view presented in this article, i.e. the attempt to reconcile the demands of neutrality and the challenges of territoriality under the auspices of the concept of coherence, is intended to provide both intellectual guidance and political balance to the application of the fundamental freedoms in respect of taxation. On the one hand, it confirms several explicit basic assumptions of the ECJ, i.e. the unilateral perspective on non-discrimination, the respect for disparities in domestic legislation and the unresolved issue of double taxation that results from the parallel exercise of taxing powers. On the other hand, it dismisses implicit and vague assumptions regarding mutual interdependence of tax legislation and the concomitant assignment of duties and responsibilities to the Member States involved. There is no material EU concept of income and there is no enforceable EU principle of one-off taxation and one-off deduction.

What are the limits to this view? At this point in the development of EU tax law, it is unanswered as to what extent the Member States are entitled to find common solutions for cross-border activities on a bilateral or multilateral basis that might deviate from the requirements of one-sided tax neutrality to foster one-off taxation and one-off deduction. In some judgements of the ECJ, we find hints and allusions in this respect: In *De Groot*,[241] the ECJ was willing to let the residence Member State off the hook if it had a reliable agreement with the source Member States regarding the allocation of personal deductions and allowances. In *Thin Cap Group Litigation*,[242] the ECJ showed some sympathy for cross-border agreements on thin capitalization, as long as the overall tax burden would only be transferred between the Member States and not increased to the detriment of the taxpayer. In its jurisprudence on withholding taxes, the ECJ referred several times to the legislative option to compensate for an unlawful withholding tax in one Member State by granting a tax credit in the other Member State.

In these judgements, the ECJ is hesitant to assign too much leeway to Member States so as to prevent "log-rolling" between tax authorities to the detriment of the taxpayer. The result, as realized under tax neutrality, should not be called into question. The current tendency to empower the Member States under the heading of "balanced allocation of taxing powers" so as to erect tax barriers between their respective territories should not be corroborated. But Member States should be entitled to create an international system where a benefit to which a taxpayer is entitled with regard to one Member State could be granted by the other Member State and where a specific tax burden on cross-border activities, which is applied by one Member State, could be compensated by another Member State. These questions will play a major role in the future, both when the Member States agree to alleviate double taxation in the European Union and when they combine to ensure the one-off taxation of income and assets in order to maintain tax sovereignty and economic efficiency, while, at the same time, creating a harmonious network of international commitments that ensures a safety net for taxpayers and taxing states, which is what Klaus Vogel dreamed of and worked for.

241. *De Groot* (C-385/00), at para. 99.
242. *Thin Cap Group Litigation* (C-524/04), at paras. 48-56.