United States Experiences with Tax Competition: Potential Answers for Germany and the European Union

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Preface

Due to the early date of my presentation, I am not able to come up with deliverables yet. The aim of this paper therefore is to provide background information on the European tax competition as the starting point of the questions I intend to address to the US tax system and to explain my research objectives. In doing so, I took a broad approach which, of course, should be narrowed after the Forum.

I. Introduction

Over the last decade, tax competition became *the* major issue for the design of tax systems in the European Union[1]. Tax rates on income from capital and business profits are under massive downward pressure. National budgets therefore increasingly rely on tax revenues from less mobile sources such as consumption, labor and real property. The reason why tax competition has become such an important topic in Europe is found mainly within the legal framework of the EC Treaty and in the stringent jurisprudence of the EC Court of Justice. Low tax jurisdictions have been extremely successful with competitive strategies, because anti-discrimination provisions require Member States to guarantee free movement of goods, persons, services and capital within the common market. Due to the ECJ's court practice, the scope of countries with a higher tax level to defend the national revenue base against tax competition is very restricted. Furthermore, it is not only the guarantee of free movement which creates a strong incentive for European Member States to compete for capital and investments, but also the absence of a general revenue sharing system. Member States contributions to the EU budget are based on VAT and on the GDP. Therefore, a gain in tax revenue resulting from the attraction of foreign investors does not have to be shared and has no immediate impact on payments the Member State may receive from the EU.

To stop the race to the bottom, the European Commission promotes the adoption of a Common Consolidated Corporation Tax Base (CCCTB) for multinationals. It is not clear whether harmonization of the tax base without adoption of a minimum tax rate would be sufficient to curb tax competition at all. However, at present, it is unlikely that all 27 Mem-

[1] See e.g. *W. Schön* (ed.), Tax Competition in Europe, Amsterdam 2003.

ber States will agree on far-reaching harmonization proposals. In the meantime, until a solution at the EC level is found, Member States are restructuring their tax systems with an eye to making them more competitive on the one hand, and to fight tax evasion on the other hand. This trend becomes evident in the recently adopted Business Tax Reform 2008 in Germany, as well as in pending reform plans in France and Denmark.

The research project's purpose is to provide a better understanding of the effects of tax competition on a country's tax system from an outside perspective. An analysis of US international tax law and anti-abuse measures could promote the discussion of a reform of the international tax laws of the European Member States. In the case of Germany, it will be insightful to compare the new rules on thin capitalization with the US rules on these matters. Looking toward the future, this research could establish a starting point for the development of a common European system of international tax law within the Union as well as at the frontiers to non-EU countries. At a second level, an analysis of the development of state taxation and today's system of apportionment in the US might enlighten possible effects of the Commission's harmonization plans.

II. The phenomenon of tax competition in Europe

1. The empirical evidence

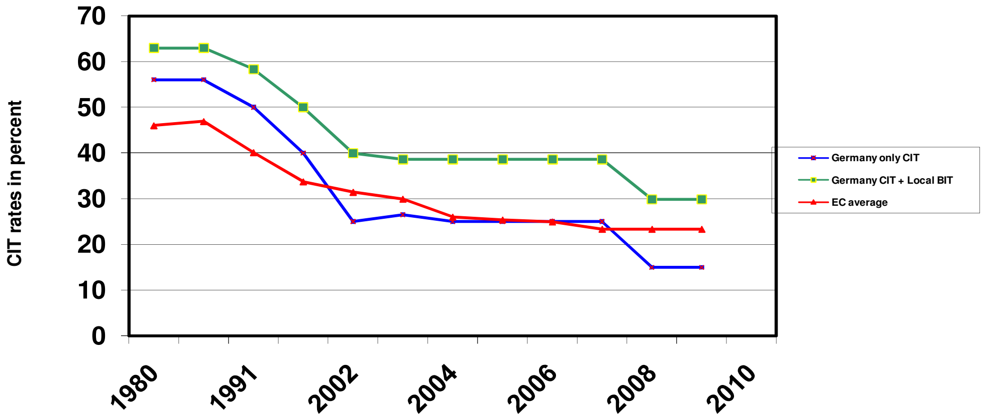
Before the EU Commission started to apply the State Aid provisions (Art. 87, 88 of the EC Treaty) to the field of business taxation[2], ring-fenced tax privileges were widely used throughout the Community. At the end of the 1990s, however, the EU Commission wielded threats of legal action against Member States for a violation of the EC Treaty in order to force Member States to change their policies. In 1997, Member States also agreed on a Code of Conduct against unfair tax competition[3].

2 See the Commission's guidelines on the application of the State Aid rules to measures relating to direct business taxation (Commission notice 98/C 384/03), OJ 1998, No. C 384 of 10/12/1998, p. 3.

3 Conclusions of the ECOFIN Meeting on 1. Dec. 1997 concerning tax policy, OJ 1998, No. C 2 p. 1 et seq., 1998; and *M. Monti*, EC Tax Review 1998, 2; *UNICE*, Intertax 1999, 76; *F. Parly*, ET 2000, 406.

From that time, competitive strategies were altered to encompass substantial cuts to the general corporate tax rates in lieu of special tax gifts to foreigners. As an often-mentioned example: Instead of its preferential Dublin Docks and Shannon Area schemes, Ireland lowered its general corporate tax rate in 2003 to 12.5 percent from a previous 32 percent. This is indicative of this shift in direction to a generalized redesign of the national tax systems within the boundaries of European law to adjust to heightened tax competition. Another reaction was the adoption of the widely-publicized dual income tax systems by the Nordic Member States. Furthermore, one of the prerequisites for membership of the Eastern European countries was that these abolish their preferential tax schemes for foreign investors, practiced up until that time. Almost all of them chose to adopt flat direct taxes and to shift the burden to indirect taxation raising their VAT rates. In doing so, they put pressure on the old Member States to follow suit. This explains the most recent cut in tax rates. Even Germany – as a traditional high tax jurisdiction – could no longer withstand this pressure. The race to the bottom – leading to a bisection of the corporation income tax rates within the last 25 years in the European Union – continues unchecked to date.

Development of coporate income tax rates in the EC and Germany since 1980



Generally speaking, Member States respond in two different manners to the pressure: positively and negatively.

On the one hand - and this constitutes the most palpable effect of tax competition - one can notice a considerable trend toward schedularism of income tax systems, with lower tax rates on mobile income sources and a shift of the burden to immobile or less mobile sources, such as income from labor and consumption. Low corporate income tax rates are an important part of this schedular system. The main aim is to attract foreign investors and not to give domestic investors a reason to relocate.

On the other hand, Member States aim to safeguard their tax revenue by measures – supposed to be anti-avoidance rules –, which at the same time serve as part of base broadening to finance the tax rate cuts. One can notice a broad variety of such measures; some are directed only against the shift of profits to low tax jurisdictions, usually limited to passive foreign investment. Most Member States devised CFC-regimes and rules against thin capitalization. Nevertheless, in detail, the structures vary extensively and therefore have the effect of creating severe distortions to cross-border activities.

2. The legal framework of EC Law

a. EC primary and secondary law

Even after the establishment of the Monetary Union, Member States vigorously defend their independency in tax politics as an inherent attribute of their sovereignty. The negotiation of the to date not yet adopted European Constitution has shown that there is no willingness at all to transfer competencies to the EC level in the field of taxation.

The EC treaty does not provide a specific article for the harmonization of direct taxes[4]. Tax harmonization can be achieved only by way of the general harmonization provision of Art. 94 of the EC-Treaty, if regulations or provisions directly affect the establishment or functioning of the common market. One could argue that tax competition and excessive anti-

4 See *J. Englisch*, The European Treaties' implications for direct taxes, Intertax 2005, pp. 310-335.

avoidance measures leading to a distortion of cross-border activities justify harmonisation. However, it is an academic question as long as the principle of unanimity impedes any headway. After the eastern enlargement of the European Union, it has become even more difficult to pass new directives, since the diverse economic positions of the Member States became more heterogeneous than in the past, and since many of the new Member States have been very successful in the race to catch up economically by employing low tax regimes. On the other hand, to curb tax competition, the interaction and cooperation of all Member States is required. Where only one state is reluctant to cooperate, this defeats all efforts undertaken. It is a field ineligible for the instrument of enhanced cooperation.

The few directives adopted to date which deal with direct tax matters affect taxpayer's opportunities to enjoy favourable tax laws of other countries directly or indirectly as follows:

The Merger Directive[5] prepares the groundwork for the transfer of real (commercial) activity through cross-border mergers: Member States are obliged to grant the same tax deferral rollovers to cross-border mergers as are available to purely domestic mergers. However, there is one important restriction: Tax neutrality is conditional upon a permanent establishment remaining in the country of the transferring company to ensure the Member State's right to tax hidden reserves generated under its tax jurisdiction. If and under what conditions Member States are allowed to tax hidden reserves immediately upon the relocation of the seat, permanent establishment or single assets of a company to another member state, is a question of the fundamental freedoms. It has not yet been adequately addressed by the ECJ.

A historic mistake was made when Member States agreed on the Parent Subsidiary Directive[6] on the one hand, and the Directive on Interest and Royalty Payments between Associated Companies[7] on the other hand. Under the Parent Subsidiary Directive, the source country is obliged to abstain from imposing withholding taxes on dividends paid to a parent

5 Council Directive 90/434/EEC of 23/7/1990, OJ 1990, No. L 225 of 20/08/1990, p. 1-5.

6 Council Directive 90/435/EEC of 23/7/1990 on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States, OJ 1990, No. L 225, p. 6.

7 Council Directive 2003/49/EC of 3/7/2003 on a common system of taxation applicable to interest and royalty payments made between associated companies of different Member States, OJ 2003 No. L 157, 49.

company (with a shareholding greater than 25 percent) located in another member state, while the country of residence must avoid double taxation either by application of the credit or the exemption method. If the exemption method is applied dividends are therefore taxed at the tax level of the state of the subsidiary. The Directive on Interest and Royalties also contains a ban on withholding taxes. In the case of a substantial shareholding of more than 25 percent, intercompany interest and royalty payments are taxed only in the residence country of the recipient of the payments, which means that intercompany loans can be used as an instrument to pay taxes *ad libitum* either in the parent's or in the subsidiary's country, permitting extensive tax arbitrage. Albeit this attribution of taxing rights is in line with the traditional benefits principle and the general practice of the DTC-law, it cements the lack of neutrality between equity and debt financing in international tax law due to the reverse attribution for interest and business profits.

For the sake of completeness, the Information Directive[8] must also be mentioned. In the past, the lack of exchange of information has surrendered the hiding of interest income a fairly low-risk activity. The adoption of the directive is an important, but possibly not sufficient step toward the comprehensive taxation of private cross-border investment income.

b. The ECJ' approach to tax competition

(1) Tax competition as natural consequence of Member States prevailing sovereignty over tax policies

Since statutory EC law does not address tax competition issues directly, the ECJ's court practice is of paramount importance. The Court's general approach to tax competition is that it is the natural consequence of the remaining sovereignty of the Member States on the one hand, and that, on the other hand, the fundamental freedoms guarantee the taxpayers' right to take advantage of rate differences and any preferential tax features. It does not even matter if the provision the taxpayer relies upon is considered to be fair or unfair in terms of

[8] Council Directive 2003/48/EC of 6/3/2003 on taxation of income from savings, OJ 2003, No. L 157, p. 38.

the aforementioned Code of Conduct[9]. Countervailing measures are reserved to the Community level. Member States defending themselves against such measures on their own authority cannot implicitly claim justification for counteracting discrimination.

In the Eurowings case[10] the ECJ refused the German government's attempt to advocate a provision of the German Local Business Tax ("*Gewerbesteuer*") with the argument that it only prevented the low Irish tax burden from becoming binding. Even if taxation at the source is substantially lower than in the resident country, in general the latter one is not allowed to tax if no comparable taxable event is provided for in domestic cases.

Although the ECJ recognizes the principle of single taxation[11], according to which taxpayers cannot claim for double non-taxation on grounds of the fundamental freedoms, the Court does not specify a certain amount of single taxation. At the moment profits are taxed once in the Community, no matter at which tax rate, the single taxation requirement is fulfilled and other Member States can not justify discriminatory tax laws by arguing that the tax levied by the other Member State is inadequately low. Between double non-taxation and low single taxation only a slender difference might exist. In my opinion, however, the ECJ's court practice simply mirrors the unclear content of the single taxation principle and demonstrates its lack of rationale.

(2) Member States' remaining sovereignty to safeguard their tax sources

After identifying the Court's general approach to tax competition, it is necessary to scrutinize to which extent Member States' sovereignty to safeguard their revenue is limited by the Court's practice[12]. It will be shown that the ECJ's concept of fundamental freedoms in

9 Cadbury Schweppes C 196/04, ECR 2006, I-7995.

10 C-294/97, ECR 1999, I-7447.

11 Regarded as an important principle of international taxation see *Avi-Yonah, Reuven S.*, Tax Competition, Tax Arbitrage and the International Tax Regime, Bull. for International Taxation 2007, 130, 133.

12 See at great length *Almendral, Violeta Ruiz*, Tax Avoidance and the European Court of Justice: What is at Stake for European General Anti-Avoidance Rules?, Intertax 2005, 562.; and *Garcia-Herrera/Herrera*, Is Fairness in Europe under Siege? EC Tax Rev. 2004, 57; *W. Schön*, Gestaltungsmissbrauch im europäischen Steuerrecht, Internationales Steuerrecht,

the field of taxation interferes with the remaining fiscal sovereignty *and responsibility* of the Member States as these are stipulated in the Maastricht Criteria. Very much in favour of the taxpayer, the Member State's power to defend its tax revenue is restricted to a narrowly-defined abuse of the fundamental freedoms.

Three basic constellations of this can be distinguished:

[1.] Relocation of real business activity;

[2.] Shifting of book profits, e.g. by financial intermediaries and transfer prices;

[3.] Tax arbitrage by taking advantage of mismatching definitions to create white income or to enjoy double-dip constructions.

[1.] As mentioned above, exit taxation is not prohibited by the Mergers Directive where the merger will result in a relocation of not only the legal seat, but also the entire business activity with the consequence that no permanent establishment will remain in the state of origin. The ECJ so far has only adjudicated on the exit taxation of natural persons with a substantial shareholding. In both the Lasteyrie[13] and the N[14] case, the Court adopted a mediator position, accepting the right of the state of origin to tax the hidden reserves accrued under its tax jurisdiction, but also holding that the immediate taxation without realization is unjust because it is disproportionate to the objective pursued. There is no reason why this rationale should not apply to the relocation of a corporation's seat or a permanent establishment as well. That means Member States have no legal basis to detain taxpayers seduced by the temptation of low tax rates offered by other Member States. The efficiency goal of the Common Market calls for a free flow of capital and enterprises according to the best investment environments. A mere tax-driven transfer might not result in the most efficient allocation. However, in case of the transfer of real business activity, the purposes for which an activity is pursued in another Member State are irrelevant[15]. No motive test would apply. Immediate taxation of the accrued reserves would only be justified in cases of a purported

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Supplement 2, 1996; *A. Kärgel*, Steuerrechtliche Anti-Missbrauchs-Regeln in Konflikt mit europäischem Gemeinschaftsrecht, Bonn 2003.

[13] Hughes de Lasteyrie du Saillant C-9/02, ECR 2004, I-2409.

[14] C-470/04, ECR 2006, I-07409.

[15] Cadbury Schweppes C 196/04, ECR 2006, I-7995 para 65.

relocation where the fictitious establishment does not carry out any genuine economic activity. However, in principle, there is no need for this, because if the enterprise does not actually move, the transaction can be disregarded as a sham and the tax jurisdiction remains unchanged.

[2.] A transfer of real activity exclusively for tax reasons will be a rare exception, since the location of a business is usually determined by many factors such as natural resources or the supply of public goods. However, the mere shift of book values and profits by financial constructions (such as debt push-down or debt push-up arrangements) permits multinationals free choice of the country where the profits will be taxed subject to minimal effort. Generation of capital income is almost independent from other location factors. Hence, the level of taxation becomes *the* key issue.

The ECJ has not presented a consistent concept on this issue yet:

[a] Also not stated explicitly in both findings[16] on cross-border group taxation, the ECJ's underlying rationale was that the fundamental freedoms do not permit an allocation of profits or losses completely independent from their origin. Multinational groups cannot claim to attribute profits to a foreign entity and have them taxed in a country different from that in which the profits were generated. Hence, domestic group tax regimes do not necessarily have to be opened to multinationals. The Court's rationale in these cases does not address questions of tax avoidance, but obviously attribution of profits in a group tax regime does not reflect real business activity, hence is a pure tax matter.

[b] These findings are coherent with the Court's practice on wholly artificial arrangements, such as fictitious establishments, which do not enjoy the protection of the fundamental freedoms. On the one hand, in the *Cadbury Schweppes* case, the Court drew strict boundaries on Member States' CFC legislation. The Court rejected the argument that the immediate attribution of the subsidiary's income does not discriminate, but only marks up the tax burden to the level of a domestic investment in the country of the parent's seat. Even if one concedes that the taxation is not higher than it would have been in a purely domestic in-

16 Marks & Spencer C-446/03, ECR 2005, I-10837; with comments by *Douma/Naumburg*, ET 2006, 431; *G. Meussen*, ET 2006, 449; *M. Lang*, ET 2006, 54; and very recently Oy AA C-231/05 of 7/18/2007, www.

vestment, the difference in treatment has to be seen in the fact that the resident corporation is taxed on the income of a different legal person before it has been actually repatriated by distribution, while between corporations of the same Member State, the separate entity principle applies[17]. However, the difference in treatment could have been justified if it "specifically relates to wholly artificial arrangements aimed at circumventing the application of the legislation of the Member State concerned"[18]. This will be the case for "fictitious establishments not carrying out any genuine economic activity in the territory of the host Member State, a letterbox or "front" subsidiary[19]. The concept stays unclear in that for fictitious establishments, no actual application of CFC legislation is required, since – as noted above - the subsidiary would remain liable to tax in the parent's country. The difference between a fictitious establishment and the concept of sham does not make sense[20]. The much more interesting question of whether the establishment of a corporation with the mere purpose to coordinate the financing activities of a group is deemed to be artificial, has not yet been resolved.

In the pending *Columbus Container* case, an issue similar to the problem of CFC-legislation is addressed, namely the issue of EC law compatibility of a switch-over from exemption to credit method where a permanent establishment earns passive income in a low tax-jurisdiction. The difference to Cadbury Schweppes is that no separate entity is involved. Hence, no comparable domestic case exists. Switch-over clauses treat foreign investments like domestic investments; both are taxed at the same level. The discrimination occurs between two cross-border investments, depending on whether the effective tax burden is considered to be too low[21].

If the Court in the *Columbus Container* case agrees that switch-over clauses fall into the scope of the freedoms at all, it must also address whether a Member State is allowed to modify double tax relief with regard to the level of taxation in the other state. Applying the

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17 Cadbury Schweppes C 196/04, ECR 2006, I-7995, para 45.

18 Cadbury Schweppes C 196/04, ECR 2006, I-7995, para 51; and the former decisions ICI C-264/96, ECR 1998, I-4695, para 26; Lankhorst-Hohorst C-324/00, ECR 2002 I-11779, para 37; de Hughes de Lasteyrie du Saillant C-9/02, ECR 2004, I-02409, para 50; Marks & Spencer C-446/03, ECR 2005, I-10837, para 57.

19 See Case C-341/04 Eurofood IFSC ECR 2006, I-0000, para 34 and 35.

20 See the criticism of *Almendra*, *Violeta Ruiz*, Intertax 2005, 562, 573.

21 Obviously there are similarities to the most favored nation issue the Court dealt with in the D-Case C-376/03, ECR 2005, I-5821; see in regard to this *Georg W. Kofler*, Most Favoured-Nations Treatment in Direct Taxation: Does EC Law Provide for Community MFN in Double Taxation Treaties?, 5 Houston Business and Tax Law Journal 1 (2005). However, the Columbus Container Case differs in that way, that the switch over stipulated in sec. 20 para 2 of the German Foreign Tax Act clause applies to all treaty partners in the same way.

rationale of Cadbury Schweppes, it will accept the application of the credit method instead of the originally-stipulated exemption method only in order to thwart an abuse. The impugned German rule probably will not meet the ECJ's narrow definition of tax avoidance, since the rule applies to all kinds of passive income (see sec. 20 para 2 and sec. 8 para 1 of the Foreign Tax Act - *Außensteuergesetz*).

[c] Recently, the Court applied the concept of "wholly artificial arrangements" to thin capitalization rules. In both cases on this issue – in the *Lankhorst-Hohorst* case[22] as well as in the *Test Claimants in the Thin Cap Group* case [23] - the Court finally held that thin capitalization rules, which focus on foreign shareholders, are discriminatory. In the first decision, the *Lankhorst-Hohorst* case, the Court took a formalistic position and disregarded the systematic dependency between the corporate and the shareholder level. In the *Test Claimants* case of 2007, the Court's opinion was already more balanced and tried to adhere to the above-mentioned principle, namely, that income should not be shifted to a country which did not contribute to its accrual.

The decision reflects the unsolved bias of international tax law between debt and equity financing. First the Court emphasized the role of the division of tax sources under international tax law[24]. European law should not urge Member States to diverge from these rules. Assuming that the set of rules applied on behalf of the OECD-Model Convention contains broadly-accepted fair principles, the Court thus far did not develop a European concept of international equity. Thin capitalization rules diverge from the general benefit principle, according to which passive investment income such as interest is usually taxed in the country of residence or seat[25]. However, the Court expressly conceded that a group's decision to fund a subsidiary by way of debt capital, rather than equity capital, can undermine the facility of a Member States to exercise their tax jurisdiction in relation to the activities carried out in their territory and thus is jeopardizing a balanced allocation of the power to tax.

22 C-324/00, ECR 2002, I-1179.

23 C-524/04, http://curia.europa.eu.

24 Case „N“: "It is in that context that the Court has already held that, in the absence of any unifying or harmonising Community measures, Member States retain the power to define, by treaty or unilaterally, the criteria for allocating their powers of taxation, particularly with a view to eliminating double taxation", furthermore Gilly C-336/96 ECR 1998, I-2793, para 24 and 30; Saint-Gobain C-307/97, ECR 1999, I-6161, para 57; de Groot C-385/00 ECR 2002, I-11819, para 93; van Hilten-van der Heijden C-513/03 ECR 2006, I-1957, para 47, 48; Kerckhaert and Morres, C-513/04, ECR 2006, I-0000, para 22, 23; Test Claimants in the Thin Cap Group C-524/04, http://curia.europa.eu, para 49.

25 Test Claimants (fn 23) para 51.

In spite of the Court being appreciative of the Member State's general concerns, the tests for the justification of thin capitalization rules remain high. Disregarding that any inter-company loan has the effect of a shift of the jurisdiction entitled to tax, requalification by way of a thin capitalization regime is only allowed in cases of intended tax evasion. Hence, the Member State has to set out "objective and verifiable elements" which allow it to identify "the existence of such a purely artificial arrangement, entered into for tax reasons alone". Secondly, even if it is proved that there are no economic reasons besides tax motives for the arrangement, the arrangement may not be totally disregarded. The interest may be treated as a distribution only to the extent it exceeds that which would have been agreed to at arm's length.

A thin capitalization rule in keeping with these restrictions could be limited to cross-border loans without violating the freedom of establishment or capital. However, it is not very likely that Member States can rely on these guidelines. It will be almost impossible to design a rule which meets the requirements of the ECJ and at the same time sufficiently forecloses the shift of profits. The arm's length principle might be suitable to identify exaggerated interest rates, but there is no arm's length standard for a specific ratio between debt and equity financing of a corporation.

Despite this criticism, it should be acknowledged that in *Test Claimants in the Thin Cap Group*, the ECJ alluded to a way to overcome this dilemma when it stated that a requalification from interest into dividends could be justified if the parent's residence country would avoid any disadvantage by treating the interest as a tax-exempt dividend instead of taxing it as interest[26]. That leads to the conclusion that a harmonized thin-cap rule which would apply in all Member States equally and therefore would avoid qualification conflicts would be in line with the EC treaty.

[3] Returning to tax arbitrage, where the taxpayer takes advantage of qualification conflicts arising from the lack of harmonization, one can interpret the ECJ's court practice such that Member States are allowed to undertake measures to prevent double-non taxation or a double deduction of losses or expenses. In such situations, the different treatment of cross-border investments can be justified on the grounds of the coherence principle. Even though

26 Test Claimants (fn 23) para 55, 56.

the Court's treatment with respect to the coherence principle has been criticized – for good reason – as being extremely questionable due to its lack of continuity and consistency, the interaction of the Member States' not yet harmonized tax systems plays an important role in the Court's reasoning. For example, in the *Marks & Spencer*[27] case, the ECJ invented a new basis for justifying different treatment when it accepted that Member States must be able to protect themselves from the danger that losses will be offset twice in different jurisdictions. Unfortunately, the court did not tie this new reason of justification to its previous case law. It did not follow the advocate general's opinion, which applied the coherence principle in a very instructive way.

It is important to stress that justification of measures against tax arbitration on the grounds of the coherence principle is not restricted to artificial arrangements and does not depend on the motives of the taxpayer.

(3) Tax competition between Member States and third countries

Within the Community itself, there is such a significant gap between the rates of corporate income tax that Member States must aim to defend their tax sources against their European neighbours. However, the traditional problem of the tax oasis must additionally be resolved. This raises the question of whether European law limits Member States' sovereignty to apply anti-avoidance rules which are directed only against tax havens in third countries. Art. 43 and 48 of the EC-Treaty guarantee the freedom of establishment only within the Community. In contrast, the wording of Art. 56 of the EC Treaty does not contain such a limitation for the free movement of capital. It is therefore highly controversial whether cross-border capital transactions to third countries may be entitled to claim equal tax treatment in reliance on Art 56 of the EC Treaty. Some commentators deny the third-country ('external') application of Art. 56 EC Treaty to tax matters *a priori*. More persuasive, however, is the opinion that Art. 56 of the EC Treaty does apply to tax legislation in respect to capital transactions to third countries, but that restrictions are more easily justifi-

27 Marks & Spencer C-446/03, ECR 2005, I-10837 para 47.

able than in intercommunity cases, especially because third countries do not fall into the scope of the Directive on Mutual Assistance[28].

To date, the ECJ has refused to give a clear answer to the question of the scope of the free movement of capital provisions, but seeks to avoid the crucial issue by arguing that the freedom of establishment takes supremacy over the freedom of capital[29]. This has the consequence that the latter freedom is legally excluded and is no longer applicable as soon as the freedom of establishment has been successfully invoked. This approach is not convincing. It leads to the illogical consequence that Member States could discriminate against substantial investments in third countries, but are prohibited from doing so in the event of portfolio investments, because here, only the free movement of capital would apply.

c. EC Commission's approach towards tax competition

As mentioned above, the EC Commission takes a double-track approach to tax competition: Besides fighting unfair tax privileges by the means of the State Aid provisions, it pushes a comprehensive harmonization project: The Common Consolidated Corporate Tax Base (CCCTB). Alignment of the rules to determine the corporate tax base would not only lower the compliance cost of cross-border investments, which today have to deal with 27 different sets of rules, but is expected to limit tax competition by rendering the shifting of profits worthless.

The project so far was quite successful in identifying rules for the calculation of the tax base with IFRS as a starting point. However, because of the transparency achieved, a harmonized tax base would even increase the rate competition. A uniform tax base is only half the battle, if it is not accompanied by a broadly accepted mechanism regulating how the commonly-determined tax base is to be shared by the involved Member States.

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28 Concerning direct taxation see Council Directive 2004/56/EC of 21/4/2004 amending Directive 77/799/EEC concerning mutual assistance by the competent authorities of the Member States in the field of direct taxation, certain excise duties and taxation of insurance premiums, OJ 2004 No. L 127, 29/04/2004, p. 70 – 72.

29 Fidium Finanz C-452/ 04, ECR 2006, I-9521.

In a study published in 2007 eexamining different methods of attribution of the tax base, the Scholars' Advisory Board of the German Federal Ministry of Finance[30] came to the conclusion that neither a formula apportionment system, as is featured by the Commission, nor a separate-entity accounting with attribution of the profit to the parent and a credit for taxes paid at source can assure the elimination of the distortions caused by the rate differences. On the other hand, even after an extensive discussion, the Scholar's Advisory Board could not bring itself to plead for a minimum corporate income tax rate. Perhaps the Scholar's Advisory Board's assumptions were too negative, especially regarding the distortion effects of formula apportionment[31]. For that reason, it will be insightful to study the technique and effects of the US apportionment system.

3. Recent German answers to tax competition: Business reform 2008

a. Increase of attractiveness by creating elements of a dual income tax

How did Germany react to the challenge of tax competition? For a long while, the German tax legislator tried to ignore the necessity of change, even after other European Member States had already adopted highly-competitive tax systems. Until the middle of the 1990s, Germany stuck to a high-tax policy with a tax system relying essentially on the taxation of mobile tax sources, imposing a high tax burden on corporate profits and a comparatively low VAT. For a long time the dogma that the corporate tax rate should equal the top rate of the personal income tax hindered Germany in following the worldwide trend of decreasing corporate income tax rates. But, at the end of the last decade, Germany eventually joined the Europe-wide trend of lowering the tax burden on corporate profits. The Tax Reduction Act (*Steuersenkungsgesetz*)[32] of 2000 already resulted in a cut of the corporate income tax rate from 40 percent to 25 percent. The next cut to 15 percent will be effective as of the

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30 *Wissenschaftlicher Beirat beim Bundesministerium der Finanzen*, Einheitliche Bemessungsgrundlage der Körperschaftsteuer in der Europäischen Union (Common Corporation Income Tax Base for the European Union), Schriftenreihe des BMF (Series of the Federal Ministry of Finance), Berlin 2007.

31 Different *Sorensen, Peter B.*, Company Tax Reform in the European Union, 11 Journal of Tax and Public Finance, 1 (2004).

32 Federal Law Gazette 2000, of 10/23/2000, Part I, p. 1433.

year 2008, created through the Business Tax Reform Act 2008[33]. Thus, due to the pressure of international tax competition within the last 20 years, corporate income tax went from 56 percent to 15 percent as of 2008[34]. Of course, with the local business tax added on, Germany will not move into the European low-tax jurisdictions, but remains at a sum level of around 30 percent for corporate profits. Still, this means a rate cut of over 8 percent compared with today's 38.6 percent.

The Business Tax Reform 2008 is completely governed by the goal of achieving competiveness. In addition to the rate cut for corporate profits, sole proprietors and partnerships are entitled to preferential personal income tax rates for retained earnings of 28.25 percent, instead of the regular progressive personal income tax tariff, which can amount to 45 percent. The aim is to prevent these entities from changing their legal form just for tax purposes[35]. Furthermore, from the year 2009 on, private capital income will be taxed at a final withholding tax rate of 25 percent[36].

Hence, Germany is following the pathway of schedularism down which most other European countries ventured before. The German income tax system has always been schedular given the dualisms of the source income principle, which leads to almost tax-free private capital gains, and the S-H-S definition of business profits. However, the application of different tax rates to different categories of income achieves a new dimension.

It is worth noting that the German Constitutional Court – quite influential in the field of taxation – very recently accepted tax competition and the legislative aim to raise Germany's competiveness as a legitimate justification for breaking with the equal treatment clause under the condition of the rule of reason[37].

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33 Federal Law Gazette 2007 of 8/14/2007, Part I, p. 1912.

34 50 percent in financial years 1990-1993, 45 percent in 1994-1998, 40 percent in 1999 and 2000.

35 Partnership play a very important role in Germany, since they represent around 80-85 percent of all business enterprises, and even large multinational groups are not necessarily incorporated.

36 Plus Solidarity Surcharge altogether 26.4 percent.

37 German Constitutional Court of 21. 6. 2006 - 2 BvL 2/99, Proceedings of the German Constitutional Court (BVerfGE), Vol. 116, p. 164.

b. Tightening of anti-avoidance rules

Mainly because of the unsolved problem of German municipalities relying on the revenue from the local business tax, even after 2008, the overall burden of around 30 percent will considerably exceed the European nominal corporate income tax rate of 23.5 percent on average. And the race to the bottom continues: further reductions by other European countries are already scheduled.

The Business Tax Reform 2008 therefore not only contains measures to increase attractiveness, but also tightens up anti-avoidance provisions (in particular by a reform of the rules on thin capitalization, new rules on earnings stripping and on the tax consequences of cross-border reallocations of services and activities).

These measures are highly controversial due to their negative economic side effects. At first, most of them are not precisely designed to combat tax arbitrage or circumvention, but involve an unsystematic base broadening in order to finance the costs of the rate cuts. The tax avoidance justification itself is prone to abuse in order to create new tax liabilities, aside from the originally-provided justifications. It might be difficult to define tax avoidance in abstract provisions, however, the German legislator seems to use a sledgehammer to crack a nut, causing not only "collateral damages", but distorting business decisions in a very rigorous manner.

Secondly, the new so-called anti-avoidance rules cause severe breaches of tax treaty law and undermine fundamental principles of the German tax system. The new cap on interest (*Zinsschranke*)[38] – allegedly similar to the US earnings stripping limitation, but in truth, much more heavy-handed in its execution – will lead to the non-deductibility of interest, no matter if it is paid to a shareholder or a third party, and no matter if it is taxed as interest at the recipient level. It is not directed against purely artificial arrangements in the sense of the ECJ. Therefore, to avoid infringement of the EC Treaty, the "cap on interest"-rule is applicable without distinction to domestic loans as well as to cross-border loans, even though, in a purely domestic context, it does not matter if the profit is taxed at the level of the subsidiary and then distributed in a tax-exempt manner to the parent, or if it is deducted as interest

38 Sec 4h of the Personal Income Tax Act; sec. 8a para 2 and 3 of the Corporation Income Tax Act.

from the income of the subsidiary and taxed as interest income at the parent's level. The only justification for violation of the net principle from the domestic point of view is to avoid a conflict with EC law in cross-border cases.

In addition, the legislators intention to tax potential profits in the event of a transfer of functions (including any chances and opportunities) threatens the realisation principle as well as the arm's length principle.

Some of the rules might be susceptible to challenge before the German constitutional court on the basis of a violation of the ability to pay principle and the equal treatment clause. However, the breach of DTC-law has no immediate legal consequences. Though pursuant to sec. 2 of the German General Tax Code, tax treaties take precedence over domestic law, conflicting domestic law adopted after the treaty will override it. The prevailing opinion on the matter considers that treaty overrides are not a problem of constitutional law. It might be a violation of international law, but the risk that Germany will be formally called to account for it, is negligible. The relationship between the treaty parties, of course, might be affected[39].

Summing up, the new set of rules does not mainly serve the purpose of preventing tax avoidance. They are not exclusively directed against low tax jurisdictions, but instead seek to shelter the German tax base in a more generalized way.

The Business Tax Reform 2008 is only one part of a comprehensive strategy of safeguarding the German tax base. As a high-tax country, measures against tax evasion have a long tradition in Germany. As early as 1972, the Foreign Tax Act (*Außensteuergesetz*) was enacted implementing a departure tax and a CFC-regime. German CFC-legislation has been tightened several times. Nevertheless, subject to a challenge to conformity with the EC treaty, the German legislator does not plan to abolish the CFC-regime. The only reaction to the above-mentioned *Cadbury Schweppes* decision was a circular published by the Federal Ministry of Finance to define the activity clause in line with the ECJ's findings[40]; this es-

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39 See examples for such solo attempts and their consequences *Avi-Yonah, Reuven S.*, Tax Competition, Tax Arbitrage and the International Tax Regime, Bull. for International Taxation 2007, 130, 131.

40 Bundessteuerblatt I (Bull. of the Ministry of Finance) 2007, 99.

sentially left the rules unchanged. The German tax legislator recognizes the CFC-legislation as a suitable instrument not only to shelter its own revenue from tax competition, but even to take advantage of low taxes abroad by way of a strict application which allows the override of treaty commitments given in the past, even in situations that cannot be considered as an abuse by the single taxpayer[41]. This practice might end up in a "reverse beggar-thy-neighbour-policy".

c. Would a change from the exemption to the credit method help?

As with most other continental European countries, in its double tax conventions, Germany usually applies the exemption method to profits from foreign permanent establishments, while unilaterally granting only a foreign tax credit or deduction (sec. 34c PIT). Intercompany dividends are tax exempt to up to 95 percent according to German domestic law, which in general applies without any threshold to dividends from abroad in the same way as to domestic dividends.

Today, the use of the exemption method is already limited in several ways, namely in the case of passive investment income. The more recently-concluded German double tax treaties usually contain activity clauses, limiting tax exemption of income from permanent establishments and inter-company dividends through a reservation clause for active business income[42]. As mentioned above in the context of the Columbus Container case, a unilateral switch from the exemption to the credit method is provided for if a permanent establishment earns low-taxed passive investment income (sec. 10 para 2 Foreign Tax Act). Furthermore, since 2007, the exemption method will be denied in the event of qualification conflicts if the other state applies the provisions of a treaty in a way that gives rise to an exemption of the income or taxation at a reduced rate, or fails to tax the income because it is derived by a person that is not subject to tax in the other state (sec. 50d para 9 Personal Income Tax Act).

41 See the criticism by *Endres/Thies*, Intertax 1998, p. 293 (300).

42 See the overview in *Klaus Vogel*, Double Tax Treaties, 4rd ed., München 2000, Art. 23 paras. 88 ff., 110 ff.

As described, to date, the credit method is – unilaterally or bilateral – only applicable to *passive* foreign income or to prevent double non-taxation. In German commentary, the exemption method has traditionally been favoured. Especially *Klaus Vogel*[43], one of the most important German writers in international tax law, argued that the competition concept of the Treaty of Rome relies on the source principle and capital import neutrality[44]. But in the light of tax competition, the imputation method won new advocates[45] who argue that a general turn to the credit method would mitigate the pressure from tax competition because domestic taxpayers would no longer enjoy advantages from shifting profits to countries with a lower tax level.

From a theoretical point of view, the credit method might feature some advantages. Concerning the legal environment of the German tax system, however, the effects of a general application of the credit method – apart from the very unlikely change of almost all existing double tax treaties – seem to be overestimated. First of all, an immediate effect would only occur in regard to the profits of permanent establishments and at the time corporate profits are repatriated by distribution. Until that time, low-taxed profits can be sheltered in a foreign subsidiary unless CFC-taxation applies. Secondly, the credit method is no *carte blanche* for high tax rates, because it then simply forces enterprises to relocate their seats instead of only shifting the profits with even worse effects for the economy in whole, since important business functions tend to be accumulated in the country of seat[46]. Finally, under EC law, it is not permitted to restrict the deduction of foreign losses if the credit method applies. While it is not decided yet whether under the exemption method foreign losses may

43 See *Klaus Vogel*, Worldwide vs. source taxation of income, Intertax 1988, p. 216 (310 ff.); Taxation of Cross-Border Income, Harmonization and Tax Neutrality under European Community Law, 1994; see also *Moris Lehner,* Competition of Tax Systems in the Mirror of European and American Tax Politics, Steuer und Wirtschaft 1998, p. 159 (169-173); *Gerd Morgenthaler*, Internationales Steuerrecht 2000, p. 289 (192/293).

44 See *Lehner, Moris*, Competition of Tax Systems in the Mirror of European and American Tax Politics Steuer und Wirtschaft 1998, p. 159, 172-173.

45 *Heinz-Jürgen Selling*, Germany's role in international tax competition, Internationales Steuerrecht 2000, p. 225, 230; *Berndt Runge* Harmful Tax Competition in the European Union and OECD Countries, in: Tax Law and European Integration, Essays in honor of Albert Rädler, 1999, p. 559, 578.

46 In a similar direction see the criticism of the territoriality principle by *Steven V. Melnik*, Corporate Expatriations – The Tip of the Iceberg: Restoring the Competitiveness of the United States in the Global Market Place, 8 NYU Journal of Legislation and Public Policy 81 (2004-2005).

be neglected, and it is likely that no immediate loss offsetting is required, the Court stated several times that if the worldwide income principle with a credit for foreign taxes is applied, it may not be applied only to profits, but must also consider losses as well[47].

The main reason, however, why a shift to the credit method is senseless lies in the odd German business tax structure with a comparatively low corporate income tax rate of 15 percent (from 2008) and a high local business tax of - on average - 14 percent, which applies only to business earnings generated in Germany. Therefore, even if profits of foreign permanent establishments were to be included into the corporate tax base, they would not be subject to the additional local business tax, and the benefit of the credit method over the exemption method from the fisc's point of view would be reduced to situations in which the foreign tax rate is below 15 percent.

4. Intermediate conclusion

From an economic point of view and in political theory, the evaluation of effects of tax competition has not yet been concluded. Neither the effects on public spending nor those on the effectiveness of allocation of resources have turned out to be so significant as to render it possible to give a clear answer to the question of benefits or detriments.

The assessment of tax competition is closely related to the underlying income concepts of either a capital-based income tax or a consumption-based income tax. Are preferential rates for capital income recognized as exemptions, which have to be designed as narrowly as possible, or are they a consequent expression of a lifetime view and therefore justified by the concept of income? A low flat tax clearly would not encroach upon the equality of taxation in accordance to the ability to pay principle, but a competitive tax rate may not be affordable if applied to all categories of income. In contrast, a schedular income tax system with a low tax burden on capital and a significantly higher taxation of labor and other less mobile sources may be neutral from an intertemporal point of view, but can it also be justified concerning horizontal and vertical equity?

47 In the two judgments against Germany in this field, the government was not able to justify the preclusion as anti-avoidance provision; see Ritter-Coulais, Rs. C 152/0, ECR 2006, I-1711 and Rewe Zentralfinanz of 3/29/2007 C-231/05, www.curia.europa.eu.

I definitely do not want to add a new chapter to the controversial debate of the economic effects and appraisal of tax competition, although economic effects, of course, can not be neglected. From a legal point of view, the loss of fairness and equality between different groups of taxpayers according to their mobility is striking. The idealistic view of *Friedrich A. von Hayek*[48] of competition as a fundamental principle of evolution and discovery leading to better solutions has thus far not come true in tax law, because Member States do not compete for the best tax system in terms of fairness, equal treatment and administrative feasibility, but instead, for the biggest bite of tax revenues. Tax systems, which were constructed in the early 20th century on the grounds of the ability to pay principle, are vulnerable to losing their former rationale in the 21st century. Taxpayers are no longer to be taxed according to their ability to pay but instead, based on their ability to move. The adaptation of the tax systems to tax competition also increases their complexity. Moreover, countries are no longer willing to obey the bilateral restrictions they agreed upon in former times, but no rationale alternative is provided for, because the double tax convention system has not yet adapted to the challenge of open economies heavily competing.

However, despite of their desirability, neither full harmonization nor an EU corporate income tax are likely to be adopted in the foreseeable future. In particular, the transfer of the corporate income tax to the EU level, which might be the easiest way to end European tax competition, is not advisable without strengthening the democratic structures. Consequently, the draft of the EU constitution does not contain taxing power of the EU.

Therefore the questions, I hope to find suggestions for in the US system, have to be scaled down as follows:

1. Does the ECJ's court practice lead to a fair attribution of tax sources among the Member States? And it if not, how does it have to be altered?
2. Under which conditions will a CCCTB serve the goal of mitigating tax competition?
3. What are appropriate means for the Member States to shelter their tax sources in line with the fundamental freedoms on the one hand and causing as little economic distortions as possible on the other hand?

48 *Friedrich A. Hayek*, The Meaning of Competition, in: Individualism and Economic Order, Chicago 1972.

4. If Member States decide to cooperate how could a common system of anti-avoidance rules be designed for application among the Member States and for application in relation to third countries?

III. The US experience with and approach to tax competition

1. US reception of tax competition in legal and economic literature

In Germany, the theoretical evaluation of tax competition is basically left to economists. The economic U.S. literature[49] has been widely recognized. For that reason, I do not expect too many new aspects from the economic literature; much more, I am interested to discover if there is a discussion of the legal aspects of tax competition. I do not except that to be a constitutional question in the U.S.[50], as it has been in the above-mentioned opinion of the German Federal Constitutional Court. But it would be interesting to know if there is a legal debate of the influence of the competition in the terms of equity and fairness of the tax system. Furthermore: What is the general assessment from the view of the international tax system? Is there a re-evaluation of the principles of international equity in the light of the competition? What is the appraisal of the official tax policy of the US regarding international tax law, which seems to be far-reaching in its attempt to protect revenues and assert taxation rights, from an academic point of view? Finally, is there a distinction in the perception of worldwide tax competition and tax competition at state level?

Literature, which shall be studied:

- The President's Advisory Panel on Federal Tax Reform, Simple, Fair and Pro-Growth: Proposals to Fix America's Tax System (2005)
- *Ault, Hugh J.*, The Importance of International Cooperation in Forging Tax Policy, 26 Brooklyn Journal of International Law, 1693 (2001)

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49 I refer to authors like *William D. Andrews*, A Consumption-Type or Cash Flow Personal Income Tax, 87 Harv. L. Rev. 1113 (1974); *Alvin C. Warren*, Fairness and a Consumption-Type or Cash Flow Personal Income Tax, 88 Harv. L. Rev. 931 (1975); *David F. Bradford*, The Choice Between Income and Consumption Taxes, 16 Tax Notes 715, 717-18 (1982); *Barbara H. Fried*, Fairness and the Consumption Tax, 44 Stan. L. Rev. 961 (1992).

50 See *Stephen W. Mazza and Tracy A. Kaye*, Restricting the Legislative Power of Tax in the United States, 54 American Journal of Comparative Law (2006), 641.

- *Avi-Yonah, Reuven S*., Globalization, Tax Competition, and the Fiscal Crisis of the Welfare State, 113 Harvard Law Review 1573 (2000)
- *Avi-Yonah, Reuven S.*, Corporations, Society, and the State: A Defense of the Corporate Tax, 90 Virginia Law Rev. 1193 (2004)
- *Avi-Jonah, Reuven S.*, The Three Goals of Taxation, 60 Tax Law Review 1 (2006)
- *Avi-Yonah, Reuven S.*, Tax Competition, Tax Arbitrage and the International Tax Regime, Bull. for International Taxation 2007, 130
- *Graetz, Michael J.,* The David R. Tillinghast Lecture Taxing International Income: Inadequate Principles, Outdated Concepts, and Unsatisfactory Policies, 54 Tax Law Rev., 261 (2001)
- *Green, Robert A.:* The Future of Source-Based Taxation of Income of Multinational Enterprises, 79 Cornell Law Review, 18 (1993)
- *Roin, Julie,* Competition and Evasion: Another Perspective on International Tax Competition, 89 Georgetown Law Journal 543 (2001)
- *Rosenbloom, H. David,* The David R. Tillinghast Lecture International Tax Arbitrage and “the International Tax System”, 53 Tax Law Rev. 137 (2000)
- *Shaviro, Daniel N.,* Money on the Table?: Responding to Cross-border Tax Arbitrage, 3 Chicago Journal of International Law 317 (2002)
- *Shaviro, Daniel M.*, More Revenues, Less Distortion? Responding to Cross-border Tax Arbitrage, 1 NYU Journal of Law & Business, 113 (2004)
- *Shaviro*, *Daniel N.,* Replacing the Income Tax with a Progressive Consumption Tax, 103 Tax Notes 91, 103-06 (2004)

2. How is the United States’ federal tax law affected by tax competition?

a. Empirical evidence

After the United States’ 1986 reform, which achieved worldwide recognition because of its significant rate cuts, the US has apparently not subscribed to a further policy of lowering the corporate income tax rate. At least compared with the situation in the European Union, the federal corporate income tax of 35 percent continues to be comparatively high, especially considering the additional state corporation taxes. To defend such a high level of taxation, an extensive body of anti-avoidance rules is apparently required, which shall be studied in a second step. In a first step, I want to look more generally at the degree to which tax competition does impact on tax legislation in the United States and how it is reflected in tax reform proposals, for example in the discussion about the implementation of a VAT. In the second step, the federal rules that aim to shelter the domestic tax base shall be investigated as to whether they serve the anti-abuse purpose effectively and whether they avoid causing severe distortions.

b. The institutional framework

A thorough examination of the conceptual and legal framework of US international tax law is inevitably necessary to indicate the degree to which US rules can be a model for tax reforms in Europe.

(1) Legal restrictions to the US policy of anti-avoidance measures

The main difference between the European Member States and the US, which might limit the comparability of the tax shelter policies, is, of course, the absence of the boundaries of the fundamental freedoms. On the other hand, Art. 24 of the U.S. Model Treaty also contains a non-discrimination clause.

(2) Worldwide versus territorial taxation

In contrast to most European countries, the US retains the right to tax worldwide income and relies on the credit method to prevent international double taxation. How does this influence the US position in international tax competition? Aside from the general passive loss limitation of section 469 IRC, are there any specific restrictions to the principle of worldwide taxation according to foreign losses or related business expenses, incurred from (passive) investment in a low tax jurisdiction? And what are the deliberations of the President's Advisory Panel on Federal Tax Reform[51] to propose a move to the territoriality principle for active business income and an exemption for foreign dividend income[52] as has been very recently discussed in Great Britain as well[53]?

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51 President's Advisory Panel on Federal Tax Reform, Simple, Fair, and Pro-Growth: Proposals to Fix America's Tax System 103 (2005), www.taxreformpanel.gov/final-report.

52 *Paul R. McDaniel*, Territorial vs Worldwide International Tax Systems: Which is Better for the U.S.?, 8 Florida Tax Review (Fla. Tax Rev.), 283 (2007); *Claire Waide*, The President's Panel's Recommendation to Move from a Worldwide Tax to a Territorial Tax System, 12 Law and Business Review of the Americas 373 (2006); *Peter Merrill, Oren Penn, Hans-Martin Eckstein, David Grosman & Martijn van Kessel*, U. S. Territorial Tax Proposals and the International Experience, 42 Tax Notes Int'l 895 (Jun. 5, 2006); furthermore *Harry Gru-bert and Jack Mutti*, Taxing International Business Income: Dividend Exemption versus the

Literature:

- *Avi-Yonah, Reuven S.,* The Rise and the Fall of Arm's Length: A Study in the Evolution of U.S. International Taxation, 15 Virginia Tax Rev. 89 (1995)
- *Avi-Yonah, Reuven S.*, All of a Piece throughout: The four Ages of the U. S. International Taxation, 25 Virginia Tax Rev 313 (2005)
- *Graetz, Michael J.; O'Hear, Michael M.:* The Original Intent of U.S. International Taxation", 46 Duke Law Journal, 1021 (1997)
- *Tsilly, Dagan,* The Tax Treaties Myth, 32 New York University Journal of International Law and Politics 939 (2000)

(3) The US concept of tax evasion and tax avoidance

Against the above-mentioned background of the different positions of ECJ and Member States on the definition of tax avoidance, it will be instructive to dissect the US concept. Apparently there is a discussion in the US literature as well on the question as to whether rules that aim to defend the domestic tax base should be based on a motive test or simply formulated according to objective elements no matter what the taxpayer's purpose is. From the starting point of this scholarly debate, I want to study the common underlying principles guiding the design of US anti-avoidance rules. For a better understanding of the US concept of international tax avoidance, it will also be necessary to scrutinize the *substance over form doctrine* in cross border situations[54]. For example: How is the term "good economic reasons" perceived? Based upon this analysis, it might be possible to give input to the development of a more convincing concept by the ECJ.

Literature:

- *Katz, Leo*, In Defense of Tax Shelters, 26 Virginia Tax Rev., 799 (2007)
- *Shaviro, Daniel M.*, Corporate Tax Shelters in a Global Economy, Washington 2004, p. 27-40
- *Shaviro, Daniel M.*, In Defense of Requiring Back-Flips, 26 Virginia Tax Rev., 815 (2007)
- *Weisbach, David A.*, Ten Truth about Tax Shelters, 55 Tax Law Rev. 215 (2002)

Current System, Washington 2001; *Hines, James*, The Case against Deferral: A Deferential Reconsideration, 52 National Tax Journal 385 (1999).

53 *HM Treasury*, Taxation of companies' foreign profits: discussion documents, London 2007.

54 See in this regard e. g. *Bankman, Joseph*, The Economic Substance Doctrine, 74 Southern California Law Review, 5 (2000).

- *Weisbach, David A.,* An Economic Analysis of Anti-Tax Avoidance Doctrines (May 17, 2002). University of Chicago Law School, John M. Olin Law & Economics Working Paper No. 99

b. Specific anti-avoidance-rules

Narrowing down to specific anti-avoidance rules, it will be necessary to confine the analysis to one or two measures. Therefore special treaty provisions will be widely disregarded.

At the moment, the most interesting aspect appears to me to be the way US tax law treats financial transactions exploiting the bias between debt and equity by the denial of the exemption from withholding for portfolio interest to shareholders owning more than 10 percent (sec. 871 (h) (3) IRC), the matching principle of sec. 267 (a) (3) IRC, and the earnings stripping rule of sec 163j IRC. Just in the opposite to sec. 871 (h) (3) IRC, the EU Interest and Royalties Directive restrains Member States – if they tax interest paid to a foreign borrower at all[55]– from levying withholding tax in case of a substantial shareholder. However, Sec. 871 (h) (3) asserts that the Interest and Royalties Directive in this respect is misguided and has to be revised. A matching principle as it is set up by sec. 267 (a) (3) IRC would not answer the problem of rate differentials, but could avoid inconsistencies because of differences in the definition of the tax base. It has to be evaluated, whether the application of matching requirements in the light of the fundamental freedoms can be justified by the coherence principle.

Another field to study could be the scope of the US controlled foreign corporation (CFC) and Passive Foreign Investment Companies (PFIC) legislation[56].

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[55] Germany, for example, would tax interest of a nonresident only, if it is secured by property situated in Germany (sec 49 para 1 No. 5 c Personal Income Tax Act).

[56] *Steines, John P.,* Whether, When, and How to Tax the Profits of Controlled Foreign Corporation, 26 Brooklyn Journal of International Law, 1595 (2001).

3. Interstate Tax Competition

At a second level, it shall be explored whether the European Union can learn from experiences made with interstate competition in the U.S.[57]

Literature:

- *Gelfand, M. David; Mintz, Joel A.; Salsich, Peter W.*, State and Local Taxation and Finance, 7. ed., 2007
- *Hellerstein, Jerome R.; Hellerstein*, *Walter,* State and Local Taxation: Cases and Materials, 8th ed., 2005
- *Joondeph, Bradley W.*, Rethinking the Role of the Dormant commerce Clause in State Tax Jurisdiction, 24 Virginia Tax Rev. 109 (2004)
- *McLure, Charles E. Jr.*, Economic Perspectives on State Taxation of Multijurisdictional Corporations 204-08 (1986).
- *Pomp, Richard D.*, The Disclosure of State Corporate Income Tax Data: Turning the Clock back to the Future, 22 Capital University Law Review, 373 (1993)
- *Shaviro, Daniel N.*, An Economic and Political Look at Federalism in Taxation, 90 Michigan Law Review, 895 (1992)
- *Shaviro, Daniel N.*, State and Local Taxation: The Current Judicial Outlook, 22 Capital University Law Review, 279 (1993)

a. Empirical evidence

It seems to turn out, that with growing importance of state taxes, competition issues gain importance. I intend to describe the noticeable effects of tax competition in the tax legislation of the states. In doing so, I will focus on corporate income tax.

b. The institutional framework

To draw any meaningful conclusions from the US states tax system, the analysis has to be thoroughly embedded in the institutional framework of both legal systems. The most striking difference between the US and the European Union is the different legal nature of both

[57] Starting point of the study will be the book of *Joann Martens-Weiner***,** Company tax reform in the European Union: Guidance from the United States and Canada on implementing formulary apportionment in the EU, New York 2006; before *J. Weiner*, Tax coordination and competition in the United States of America, Annex 9 C to the Ruding Report, ed. by the European Commission, 1992.

Unions. However, I shall only take the institutional differences into consideration to the extent that these affect the latitude of tax competition and the playing field to counteract it.

Despite of the interconnection between taxation and finance at all levels[58], compared with other federal republics, US states enjoy significant sovereignty in fiscal matters. On the other hand, they are restrained by the commerce and due process clause, which serves a similar function as the EC fundamental freedoms in that that it restricts states from applying discriminatory rules on interstate cases[59]. *Ruth Mason* recently compared the "internal consistency test" employed by the US Supreme Court to identify discriminatory rules of the states taxation[60] with the ECJ's court practice[61]. Besides that, there might be restrictions by the equal treatment clause, even though *Mazza* and *Kaye* indicate that constitutional law has played a relatively minor role in the development of tax law in the United States [62]. Furthermore, the question arises as to whether there are any restrictions to beggar-thy – neighbour-strategies as they are provided for by the state aid provisions of Art. 87 of the EC-Treaty[63].

Furthermore, it will be necessary to take into consideration state tax systems in their entirety in order to explore the existence of switch-over facilities to raise revenue from other sources. Apart from that, the question of existence and functioning of a revenue sharing system among the state or among the federal and the state level may affect this question.

Studying the historical development of state taxation may provide clues toward a pathway to a system leaving as much sovereignty to the states as possible, but which - in aiming toward a certain degree of uniformity – manages to avoid severe distortions.

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58 *M. David Gelfand; Joel A. Mintz; Peter W. Salsich*, State and Local Taxation and Finance, 7. ed., St. Paul 2007, 4.

59 Boston Stock Exch. v. State Tax Comm'n, 429 U.S. 318 (1977); Complete Auto Transit, Inc. v. Brady, 430 U.S. 274 (1977).

60 American Trucking Ass`ns, Inc. v. Scheiner, 483 U.S.266, 284 (1987).

61 See *Ruth Mason*, A Theory of Tax Discrimination, Jean Monnet Working Paper 09/2006, 5-7

62 *Stephen W. Mazza and Tracy A. Kaye*, Restricting the Legislative Power of Tax in the United States, 54 American Journal of Comparative Law (2006), 641.

63 As *Ruth Mason*, Working Paper, p. 10 with footnote 39 indicates, there are none.

c. Evaluation of the US apportionment system as a measure to share a common tax base

Finally, the US state apportionment system shall be investigated in depth to reconsider the abovementioned exhortations to the EU Commission's plan by the Scholars' Advisory Board of the German Federal Ministry of Finance. A properly-constructed apportionment system could be the key to the further development of the corporate income tax in Europe and for the likelihood of a success of the Commission's CCCTB project. In this context, it might also be interesting to study the discussion of applying formula apportionment to NAFTA[64].

IV. Possible conclusions

It might turn out that in the long run, giving up some national legislative power to the EU level by adopting a basic EU corporate income tax to which Member States are allowed to levy individual surcharges is the only way to sustain the fiscal power *and* sovereignty of the Member States. Earlier in this paper, I questioned the likelihood of such a development. However, to face the truth might be better than adhering to and defending parochial habits incompatible with the thus-far achieved degree of economic integration within the Common Market.

Apart from this general conclusion, I expect to find significantly different criteria applied to interstate vis-à-vis international taxation and tax competition. US international tax law might not be suitable to serve as a model for the relationship among the Member States, because it asserts US taxing power worldwide in a quite oppressive way, internationally enforced by the predominant economic and political strength of the US. It therefore might turn out to be too heavy-handed for application within the EU, but might be influential for the design of the international tax law in relationship to third countries, if – and that seems to be the crucial point – Member States are willing to collaborate.

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64 *Paul R. McDaniel*, Formulary Taxation in the North American Free Trade Zone, 49 Tax L. Rev. 691 (1995); *Richard D. Pomp*, Issues in the Design of Formulary Apportionment in the Context of NAFTA, 49 Tax Law Rev., 795 (1994).