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# EU INNOVATION POLICY AND THE ECJ'S ABANDONED FORAY INTO THE REALM OF NATIONAL DIRECT TAXATION MEASURES

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## ABBREVIATIONS

- AG – Advocate General
- AIFMD – Alternative Investment Fund Managers Directive
- DTC – Double Taxation Convention
- ECJ – European Court of Justice
- EESC – European Economic and Social Committee
- EU – European Union
- EuVECA Regulation – European Venture Capital Funds Regulation
- EVCA – European Private Equity & Venture Capital Association
- OECD – Organization for Economic Cooperation and Development
- SME – Small and Medium Enterprise
- TFEU – Treaty on the Functioning of the European Union
- VC – Venture Capital

# INTRODUCTION

## 1. SUMMARY

For over a decade and recently as a means to overcome the crippling effects of the credit crunch and its recessionary effects on European economies, EU institutions have initiated an expansive innovation policy centered on the development and support of entrepreneurs and emerging growth ventures. Private investment in the form of venture capital (VC) is necessary to support this policy in that the VC market provides a unique and essential link between finance and innovation. Tax incentives, tax treatment, and legal (tax) certainty are of paramount importance in both attracting entrepreneurs as well as driving the financial commitments of reputable VC funds. The high level of risk that an entrepreneurial “idea”, emerging growth venture, or start-up will never be commercialized demands both tax incentives for risk-taking as well as confidence that an investor’s exit from a VC investment will not be subjected to unfavorable tax treatment. Thus, in that cross-border investment is often considered necessary for VC funds to achieve required economies of scale in the EU, the creation of a robust VC industry demands that the risk of double taxation in cross-border investments is eliminated. At the EU-level, this risk can be immediately addressed only through the collective will(s) of the Member States as manifested in secondary legislation. Otherwise, in light of the ECJ’s 2006 decision in *Kerckhaert*, the middling VC industry of the EU appears certain to confront the Member States’ unreliable coordination of their overlapping, autonomous taxing jurisdictions under a continuing shadow of double taxation uncertainty.

## 2. AIM OF THE STUDY

The aim of this thesis is to elucidate a primary hindrance to the successful implementation of the EU’s past and current innovation policies. First, the limitation on the ECJ’s competence to eliminate taxation disadvantages (including international double taxation) which result from “disparities” inherent in the concurrent taxation measures of differing Member States in cross-border economic situations is explored. The ECJ’s case law which has established this limitation in competence and which culminated with *Kerckhaert* is assessed for its quality, consistency, and underlying legal certainty. Much emphasis is placed on the case law at the intersection of the free movement of capital and national direct taxation measures in that 1) *Kerckhaert* summarily put

an end to the question of whether the ECJ holds international double taxation to be discriminatory, and 2) the case law on capital movements is most illustrative of the Court's deference to the Member States' direct taxation autonomy.

Additionally, the effectiveness of other EU institutions in driving innovation is addressed. In particular, methods of positive tax integration are considered and evaluated for their likelihood of successful implementation. In particular, non-taxation initiatives such as the Alternative Investment Fund Managers Directive and the European Venture Capital Funds Regulation are analyzed and assessed. In sum, while the tone of the thesis may appear critical at times, the aim is merely to promote an awareness of the currently limited competences and abilities of the differing EU institutions to drive the highly ambitious goals of the EU's innovation policy.

### **3. METHOD AND MATERIALS**

Because of a personal interest in the reasons for the lack of an EU-wide VC industry to complement the EU's innovation policy, research began with a close reading and analysis of Granieri and Renda's *Innovation Law and Policy in the European Union*. Specifically, the thesis utilizes a traditional legal dogmatic approach to establish both the current state of the law at the EU level but also to analyze the competences and legal bases of the ECJ and other EU institutions to effect change. A vast array of highly conflicting legal commentary and criticism has been delivered in response to the ECJ's line of cases which culminated with *Kerckhaert*. As such, this thesis in large part endeavors to synthesize this opposing scholarship and to utilize an accurate understanding of *Kerckhaert* to comment on the case's potential effects on EU innovation policy.

### **4. OUTLINE OF THE STUDY**

Part I of the thesis ventures to summarize the economic and legal dynamics of the virtuous venture capital cycle as they pertain to the goals of the EU's innovation policy. Further, Part I introduces the reader to the role of bilateral double taxation conventions in the coordination of the Member States' concurrent or "overlapping" taxing jurisdictions. Finally, Part I touches on the ECJ's case law at the intersection of the free movement of capital and direct taxation measures. This case law is introduced to highlight its overarching relevance to the substantial

autonomy of the Member States to coordinate the allocation of taxing rights in cross-border VC investment. Subsequently, Part II of the thesis highlights key elements in the development of the free movement of capital. This historical analysis is meant to serve as a means for the reader to understand recent rulings of the ECJ at the intersection of capital movements and national direct taxation.

Part III assesses, in detail, the development of the ECJ's case law at the intersection of capital movements and national direct taxation. In particular, the ECJ's utilizations of both the non-discrimination and non-hindrance tests are addressed. Further, the Court's attempts to delineate between discrimination and mere disparity as to Member State direct taxation measures are explored. Subsequently, Part IV further analyzes the ECJ's application of its discrimination / disparity standard within the controversial line of cases which culminated with *Kerckhaert*. Finally, Part V addresses the post-*Kerckhaert* prospects for the relief of international double taxation in the EU. In particular, the Alternative Investment Fund Managers Directive as well as the European Venture Capital Funds Regulation are addressed.

## **PART I – INNOVATION POLICY AND THE NEED FOR A VIRTUOUS VENTURE CAPITAL CYCLE IN THE EU**

As what is arguably the deepest and most impactful economic crisis of modern times continues to permeate on a global scale, governments are desperate to foster economic recovery. Government policy toward “innovation” is currently a primary—if not nearly universal—means of attempting to spur economic growth and competitiveness.<sup>1</sup> In 1934, Joseph Schumpeter defined innovation quite broadly as “the introduction of new goods, new methods of production, the opening of new markets, the conquest of new sources of supply, and the carrying out of a new organization of any industry.”<sup>2</sup> More recently, the Alliance for Science & Technology Research in America defined innovation as “a process by which value is created for customers through public and private organizations that transform new knowledge and technologies into

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<sup>1</sup> Massimiliano Granieri and Andrea Renda, *Innovation Law and Policy in the European Union. Towards Horizon 2020* (Springer-Verlag Italia 2012), pp 1-2.

<sup>2</sup> *Ibid*, at 2; see also Joseph A. Schumpeter, *The theory of economic development: an inquiry into profits, capital, credit, interest, and the business cycle*. (Harvard University Press 1934).

profitable products and services for national and global markets.”<sup>3</sup> Despite the lack of a commonly accepted definition (and there are many to choose from), there is a strong consensus as to the fact that innovation requires entrepreneurs and that the optimal vehicle of entrepreneurship is the small and medium enterprise (SME).<sup>4</sup> Specifically, the SME—as opposed to larger, “track-dependent” firms bound by pre-existing business goals and methods—is considered to be ideally positioned for the successful development of high-risk, high-potential innovation.<sup>5</sup> In fact, research has found that new, small firms—or “start-ups”—have developed more than half of the 20th century’s most important innovations.<sup>6</sup>

Private investment in the form of venture capital (VC) is generally necessary to support and develop the innovative projects of SMEs.<sup>7</sup> In this sense, the VC market provides a unique and essential link between finance and innovation.<sup>8</sup> A viable VC market requires and coordinates the simultaneous availability of 1) entrepreneurs, 2) investors (typically passive limited partners) with an appetite for high-risk, high-return investments that place capital into funds, and 3) fund managers (general partners) that have the expertise to serve as “specialized financial intermediaries” between entrepreneurs and investors. The fund manager serves not only as a fundraiser, but is ultimately compensated for the ability to optimize the performance of the entrepreneurs or “portfolio companies” that are selected to compose the fund.<sup>9</sup> Thus, VC investments can be defined as a subset of private equity that targets unlisted (non-public) companies for the launch, early development, or expansion of a business. The vast majority of the invested capital is in the form of equity—as opposed to debt—and during the period that the capital is at risk, the entrepreneur and fund manager will engage in an active partnership where each of the parties is fully incentivized to share each other’s respective expertise and align their intentions. With regard to this alignment of intentions, VC has no particular use for dividends;

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<sup>3</sup> Granieri and Renda (n 1), at 2.

<sup>4</sup> Josh Lerner, ‘*Entrepreneurship, public policy, and cities*’, Policy Research working paper; no. WPS 6880. Washington, DC: World Bank Group (2014) at 3.

<sup>5</sup> Ibid.

<sup>6</sup> Ibid. See also Zoltan J. Acs and David B. Audretsch ‘*Innovation in Large and Small Firms: An Empirical Analysis*’, *American Economic Review* 78: (1988) pp 678–90.

<sup>7</sup> See Paul A. Gompers and Josh Lerner, *The Money of Invention, How Venture Capital Creates New Wealth*, (Harvard Business School Press, 2001).

<sup>8</sup> Ronald J. Gilson, ‘*Engineering a Venture Capital Market: Lessons from the American Experience*’, *Stanford Law Review*, Vol. 55, (April 2003), at 1068; See also Samuel Kortum and Josh Lerner, *Assessing the Contribution of Venture Capital to Innovation*, 31 *Rand J. Econ.* 674, (2000) at 674-75.

<sup>9</sup> See Gilson (n 8), at 1093.

rather, investment returns are usually achieved in the form of capital gains at exit—that is, either when the company is listed on a stock market or when it is sold to another investor.<sup>10</sup>

Thus, with regard to the policies and legislation crafted to remedy the “innovation emergency”<sup>11</sup> faced by the European Union (EU), much emphasis has been placed on the establishment of what has been termed a “virtuous venture capital cycle”<sup>12</sup> which focuses on 1) boosting VC fundraising (i.e., from large, institutional investors into VC funds), 2) promoting VC and other risk capital investments in promising, early-stage companies, and 3) encouraging access to capital markets in order to improve liquidity and exit opportunities that enable VC funds to return capital to their investors.<sup>13</sup> Tax systems are of the highest importance in the promotion of this cycle in that particular systems directly affect decisions to enter into entrepreneurship, the demand for VC investments, and contracting between venture capitalists and entrepreneurs.<sup>14</sup> Extensive research stresses that decreased rates of taxation for capital gains as well as favorable treatment for industry-standard stock options (e.g., convertible preferred stock) drive increases in committed capital to VC funds because of an increased demand for VC investments by entrepreneurs.<sup>15</sup>

Currently, there is a strong consensus that the EU’s VC industry does not operate to its potential due to a fragmented internal market that 1) features 28 sets of tax, legal and regulatory systems and 2) obstructs the economies of scale necessary for effective, large-scale VC investments.<sup>16</sup> The Council and the Commission have stressed that to establish an EU-wide VC market for the support of SMEs, there must be certainty that intra-EU, cross-border VC

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<sup>10</sup> OECD (1996), *Venture Capital and Innovation*, at 22; available online at: <http://www.oecd.org/dataoecd/35/59/2102064.pdf>

<sup>11</sup> See Granieri and Renda (n 1), at 53, citing to M’aire Geoghegan-Quinn, European Commissioner for Research, Innovation and Science “A Europe where we pull together, not drift apart”, Institute of International and European Affairs Brussels, 20 September 2011, SPEECH/11/592.

<sup>12</sup> See Paul A. Gompers and Josh Lerner, *The Venture Capital Cycle*, (The MIT Press, 1999).

<sup>13</sup> Janke Dittmer, Joseph A. McCahery, and Erik P. M. Vermeulen, ‘*The “New” Venture Capital Cycle and the Role of Governments: The Emergence of Collaborative Funding Models and Platforms*’ (November 20, 2013). Lex Research Topics in Corporate Law & Economics Working Paper No. 2013-7; Tilburg Law School Research Paper No. 021/2013, at 9.

<sup>14</sup> Josh Lerner and Joacim Tåg, ‘*Institutions and Venture Capital*’, IFN Working Paper No. 897, (2012) at 8.

<sup>15</sup> Ibid. See also Paul A. Gompers and Josh Lerner, ‘*What Drives Venture Capital Fundraising?*’, *Brookings Papers on Economic Activity—Microeconomics*, (1998), 149–192; and Ronald J. Gilson and David Schizer (2003), ‘*Venture Capital Structure: A Tax Explanation for Convertible Preferred Stock*’, *Harvard Law Review*, 116 (2003) 875–916.

<sup>16</sup> Report of the Expert Group on removing tax obstacles to cross-border Venture Capital Investments (2010), at 4.



investments can be executed without disproportionate administrative burdens, unfavorable tax treatment, and—most importantly—incidences of double taxation.<sup>17</sup> While the Member States rely almost exclusively on bilateral double taxation conventions or treaties (DTCs) between each other that are generally based on the Model Double Tax Convention of the Organization for Economic Cooperation and Development (or the OECD Model), these DTCs are not always effective in the allocation of taxing rights among the Member States to avoid double taxation. First, the effectiveness of a DTC can be dubious in that the complex financing / partnership structures utilized in VC funds are not always recognized or accommodated by the DTC.<sup>18</sup> Second, there is often uncertainty as to whether the cross-border “management” of a portfolio company by the VC fund manager will be deemed by differing Member States’ tax authorities to have created a permanent establishment—and thus, an extra layer of taxation—for the fund’s investors and the fund vehicle itself. Notably, most DTCs contain a provision based on Article 5 of the OECD Model that would enable investors and the fund vehicle to avoid their creation of a permanent establishment if the VC manager is deemed an “independent” rather than a “dependent” agent. Still, there is no accepted or harmonized position in the EU that the activities of a VC fund manager are such as to constitute independent agency.<sup>19</sup> Third, and finally, the specific tax treatment of VC funds varies from one Member State to another.<sup>20</sup> For example, in triangular or multi-angular tax situations where three or more Member States are involved in a VC investment (e.g., the state of establishment of the VC fund vehicle, the state of residence of investors, and the state of the portfolio companies in which the VC fund invests), double taxation may not be prevented by the DTCs because the respective tax authorities of the differing Member States may classify the VC fund in different ways (e.g., as transparent/non-transparent, resident/non-resident, subject to tax/not subject to tax and trading/non-trading).<sup>21</sup>

As the European Court of Justice (ECJ) began its sudden effort to bring the case law on the free movement of capital broadly in conformity with the restrictions-based approach of the other Treaty freedoms, the Court specifically addressed “the vexed question of international

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<sup>17</sup> *Ibid.*, at 1.

<sup>18</sup> *Ibid.*, at 1.

<sup>19</sup> *Ibid.*, pp 15-22.

<sup>20</sup> *Ibid.*, at 1.

<sup>21</sup> *Ibid.*, at 23.

double taxation” in the seminal 2006 case *Kerckhaert*.<sup>22</sup> Before this case, the ECJ had begun aggressively applying to national measures—including taxation measures—a broad definition of what amounts to a restriction of the free movement of capital in utilizing language that focused on dissuading or deterring effects.<sup>23</sup> Cases such as *Sandoz* and *Manninen* highlight the extent of the Court’s willingness to impinge on the fiscal / tax sovereignty of the Member States with broad, restriction-based language and analysis that seemed, at one point, to threaten the very core of international taxation law.<sup>24</sup> In *Manninen*, AG Kokott’s opinion specifically argued that *even* in the context of direct taxation:

[a]ny measure that makes the cross-border transfer of capital more difficult or less attractive and is thus liable to deter the investor constitutes a restriction on the free movement of capital. In this respect the concept of a restriction of capital movements corresponds to the concept of a restriction that the Court has developed with regard to the other fundamental freedoms.<sup>25</sup>

Further, in his opinion to the 2005 case *D. v. Inspecteur van de Belastingdienst*, AG Ruiz-Jarabo Colomer stated, “the fact that a taxable event might be taxed twice is the most serious obstacle there can be to people and their capital crossing internal borders.”<sup>26</sup> Yet, in *Kerckhaert*, the ECJ distanced itself from this position and what was for many the most intriguing question with regard to the application of the free movement of capital to direct taxation was settled: international double taxation was held to be not contrary to the Treaty.<sup>27</sup> Further, *Kerckhaert* and other subsequent case law evidence the ECJ’s return to its longstanding leniency for Member States’ direct taxation measures where they intersect with the fundamental freedoms—and the free movement of capital in particular.<sup>28</sup>

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<sup>22</sup> See Jukka Snell ‘Free Movement of Capital: Evolution as a Non-Linear Process’ in P Craig and G de Búrca (eds), *The Evolution of EU Law*, 2nd edn (Oxford: Oxford University Press, 2010); Case C-513/04 *Kerckhaert & Morres* [2006] ECR I-10967.

<sup>23</sup> See Snell (n 22), pp 552-58; See also John A. Usher, ‘*The Evolution of the Free Movement of Capital*’ (2008) 31:5 *Fordham Int’l LJ* 1533.

<sup>24</sup> See Snell (n 22), pp 557-62; See also Thomas Horsley ‘The Concept of an Obstacle to Intra-EU Capital Movement in EU Law’ in Niamh Nic Shuibhne and Laurence W. Gormley (eds), *From Single Market to Economic Union: Essays in Memory of John A. Usher*, (Oxford: Oxford University Press, 2012), pp 165-66; Case C-439/97 *Sandoz* [1999] ECR I-7041; Case C-319/02 *Manninen* [2004] ECR I-7477.

<sup>25</sup> *Manninen* (n 24), Opinion of AG Kokott, para 28.

<sup>26</sup> Case C-376/03 *D. v. inspecteur van de Belastingdienst* [2005] ECR I-5821 (Oct. 26, 2004), 85 (Opinion of AG Ruiz-Jarabo Colomer).

<sup>27</sup> See Snell (n 22), at 563.

<sup>28</sup> *Ibid.*

While particular non-finance components are necessary to initiate and sustain a virtuous venture capital cycle (such as a highly educated, motivated population capable of becoming entrepreneurs), tax incentives, tax treatment, and legal (tax) certainty are of paramount importance in both attracting entrepreneurs as well as driving the financial commitments of reputable VC funds. The high level of risk that an entrepreneurial “idea”, emerging growth venture, or start-up will never be commercialized demands both tax incentives for risk-taking as well as confidence that an investor’s exit from a VC investment will not be subjected to unfavorable tax treatment. Thus, in that cross-border investment is often considered necessary for VC funds to achieve required economies of scale in the EU, the creation of a robust VC industry demands that the risk of double taxation in cross-border investments is eliminated. At the EU-level, this risk can be immediately addressed only through the collective will(s) of the Member States as manifested in secondary legislation. Otherwise, in light of the ECJ’s 2006 decision in *Kerckhaert*, the middling VC industry of the EU appears certain to confront the Member States’ unreliable coordination of their overlapping, autonomous taxing jurisdictions under a continuing shadow of double taxation uncertainty.

## **PART II — BRIEF HISTORY OF THE FREE MOVEMENT OF CAPITAL**

The original capital provisions contained in the Treaty of Rome were found by the ECJ in *Casati* to lack direct effect.<sup>29</sup> Specifically, the provisions on capital movement were held to “differ from the provisions on the free movement of goods, persons, and services” in that the text of those on capital stated an obligation as to liberalization that was not imperative or absolute.<sup>30</sup> The Court held that the obligation to liberalize capital movements was highly context-specific and varied “in time and [depended] on an assessment of the requirements of the Common Market and on an appraisal of both the advantages and risks which liberalization might entail”.<sup>31</sup> Further, in holding that its obligation to liberalize capital movement was dynamic and flexible to the Member States’ economic and political goals, the Court also stressed that the assessment of the

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<sup>29</sup> Case 203/80 *Casati* [1981] ECR 2595, para 19.

<sup>30</sup> *Ibid*, para 10.

<sup>31</sup> *Ibid*; see Ryan Murphy, ‘Changing Treaty and Changing Economic Context: The Dynamic Relationship of the Legislature and the Judiciary in the Pursuit of Capital Liberalisation’ in P Syrpis (ed), *The Judiciary, the Legislature and the EU Internal Market* (Cambridge: Cambridge University Press, 2012), at 277.

obligation “is, first and foremost, a matter for the Council”.<sup>32</sup> The Court’s deference to the Council depended not only on the text of the Treaty provisions on capital as well as “the economic, pragmatic, and political ramifications of intervention in such a sensitive area”,<sup>33</sup> but also on the fact that the Council had actively adopted Directives which made clear its hesitancy as to a full liberalization of capital movements.<sup>34</sup> Indeed, the spirit of the *Casati* judgment evidenced both 1) the Court’s utmost self-restraint and deference to the legislative autonomy articulated in the Treaty and 2) the acknowledgment that “full liberalization of capital would require either the Member States to voluntarily liberalize it themselves or the EU to enact legislation”.<sup>35</sup>

Partly as a result of the Court’s decision in *Casati*, the free movement of capital was not developed at the same pace as the other freedoms.<sup>36</sup> While a series of Directives on capital movements was successfully adopted in the early 1960s, these Directives were merely a means to merge the unilateral measures on capital that had already been independently implemented by the Member States.<sup>37</sup> Correspondingly, when the Member States expressed aversion to further liberalization of capital movement at the end of the 1960s and beginning of the 1970s, the Commission acquiesced to their collective will(s). In fact, it was only when France and a number of other key Member States had reached a consensus as to the need for liberalization in the early 1980s that the Commission, again, developed into an active proponent of the free movement of capital.<sup>38</sup> Thus, at the inception of the development of the free movement of capital, the Member States were the actual “driving force” that dictated the pace and breadth of liberalization.<sup>39</sup> Further, the cautious approach of both the Member States and the European institutions as to the

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<sup>32</sup> *Casati* (n 29) para 11; R. Murphy (n 31), at 277.

<sup>33</sup> R. Murphy (n 31), at 281.

<sup>34</sup> Snell (n 22), at 550; M Poires Maduro, *We The Court: The European Court of Justice and the European Economic Constitution* (Hart, 1998) pp 76-78.

<sup>35</sup> R. Murphy (n 31), pp 277-78.

<sup>36</sup> Leo Flynn, ‘*Coming of Age: The Free Movement of Capital Case Law 1993–2002*’, 39 *Common Market Law Review* 773 (2002).

<sup>37</sup> Age F.P. Bakker. *The Liberalization of Capital Movements in Europe: The Monetary Committee and Financial Integration, 1958-1994* (Kluwer, 1996) at 88 and 93.

<sup>38</sup> *Ibid*, pp 153-154.

<sup>39</sup> See Snell (n 22), pp 550-51.

free movement of capital paralleled and was dependent primarily on prevailing economic theory (and experience) which warned strongly against full liberalization.<sup>40</sup>

It was only in 1988 that the Council adopted Directive 88/361 which held in unequivocal terms that “Member States shall abolish restrictions on movements of capital taking place between persons resident in Member States”.<sup>41</sup> The Directive was the culmination of a build-up of support for liberalization from the European institutions in the form of both the Commission White Paper on Completing the Internal Market<sup>42</sup> as well as the Single European Act 1986.<sup>43</sup> Again, though, the European institutions’ support was only initiated when a sufficient number of Member States had independently decided to relax their capital controls.<sup>44</sup> Either way, Directive 88/361 is described as the most important legislative intervention adopted by the Council in the field of capital in that it was only through this measure that full capital liberalization in the EU was enabled.<sup>45</sup> Further, Murphy goes as far to state:

Taken together, the Articles of the Directive required a high level of capital liberalization, with only limited possibilities for derogation. It is clear that the presumption of Member State legislative autonomy and control is reversed by the Directive.<sup>46</sup>

While it was only three years later in 1991 that the main obligations of Directive 88/361 were incorporated within the Treaty framework (Maastricht), another interval was required before the capital provisions entered fully into force in 1994 in conjunction with the commencement of the second stage of the European Monetary Union (EMU).<sup>47</sup> All told, it took nearly forty years for the Treaty of Rome’s “weakly worded [capital movement] Article with little legal or practical significance”<sup>48</sup> to develop into a provision capable of imposing an obligation in line with those of the other Treaty freedoms.<sup>49</sup> The unhurried development of the freedom was seemingly

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<sup>40</sup> Catherine Barnard. *The Substantive Law of the EU, The Four Freedoms* (Oxford University Press, 2013) pp 580-81; See also R. Murphy (n 31), at 279.

<sup>41</sup> Council Directive 88/361 (EEC) for the implementation of Art 67 of the Treaty (1988) OJ L178/5.

<sup>42</sup> Completing the Internal Market, White Paper from the Commission to the European Council, COM (85) 310 final (1990).

<sup>43</sup> Single European Act, Feb. 17, 1986, 29 OJ. EUR. COMM. (No. L 169) 1 (1987); See Snell (n 22), at 551.

<sup>44</sup> Maduro (n 34); Bakker (n 38); see also Snell (n 22), pp 550-54.

<sup>45</sup> R. Murphy (n 31), at 281; Barnard (n 40), at 581.

<sup>46</sup> R. Murphy (n 31), at 282.

<sup>47</sup> Snell (n 22), at 551.

<sup>48</sup> *Ibid*, at 548.

<sup>49</sup> R. Murphy (n 31), at 289.

methodical, yet intermittent, and highly dependent on the fickle collective will(s) of the Member States.

Ever since its confirmation of the direct effect of Directive 88/361 and what is now Article 63 TFEU,<sup>50</sup> the ECJ's approach to the free movement of capital has been expansive.<sup>51</sup> The Court's judgments on capital quickly began to utilize language and analysis beyond that of mere discrimination and which paralleled its case law on the free movement of goods,<sup>52</sup> persons,<sup>53</sup> and services.<sup>54</sup> The ECJ confirmed its willingness to apply a non-hindrance test to capital movements in *Commission v. Portuguese Republic (Re Golden Shares I)* where it held that a national measure is subject to what is now Article 63(1) TFEU "even though the rules in issue may not give rise to unequal treatment".<sup>55</sup> While previous capital movement case law had utilized restriction-based language such as "liable to dissuade" or "liable to impede", the ECJ's ruling in *Commission v. Portuguese Republic (Re Golden Shares I)* confirmed unequivocally the principle that even a non-discriminatory national measure is capable of facing subjection to the Treaty's free movement of capital provisions.<sup>56</sup> In fact, in applying a "non-hindrance" test to capital movements, the Court further established its acknowledgment that the mere prohibition of discrimination is insufficient and simply ineffective in assessing national measures where there is nothing in a host Member State to which one can compare in a cross-border transaction.<sup>57</sup> Still, and as the following sections will evidence, the ECJ's application of broad, restriction-based analysis in its case law at the intersection of capital movements and Member State taxation has proven to be tempered by a consciousness of the economic and political paradigm in which the Treaty operates. AG Geelhoed expresses this consciousness in his opinion that, "judicial intervention is, by its nature, casuistic and fragmented [and as] a result, the Court should be cautious in giving an answer to questions arising before it raising issues of a systematic nature.

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<sup>50</sup> Case C-358/93 *Bordessa* [1995] ECR I-361; Case C-163/94 *Sanz de Lera* [1995] ECR I-4821.

<sup>51</sup> L. Flynn (n 36), pp 778—85.

<sup>52</sup> See, inter alia, Case 8/74 *Dassonville* [1974] ECR 837; Case 120/78 *Cassis de Dijon* [1979] ECR 649

<sup>53</sup> See, inter alia, Case 41/74 *Van Duyn* [1974] ECR 1337; Case C-415/93 *Bosman* [1995] ECR I-4921

<sup>54</sup> See, inter alia, Case 2/74 *Reyners* [1974] ECR 631; Case C-76/90 *Säger* [1991] ECR I-4221

<sup>55</sup> Case C-367/98 *Commission v Portugal* [2002] ECR I-4731, para 45.

<sup>56</sup> See Steffan Hindelang, *The Free Movement of Capital and Foreign Direct Investment: The Scope of Protection in EU Law* (Oxford University Press, 2009) at 120.

<sup>57</sup> *Ibid*, at 117.

The legislator is better placed to deal with such questions, in particular when they raise issues of inherent fiscal-economic policy considerations”.<sup>58</sup>

## **PART III — THE INTERSECTION OF THE FREE MOVEMENT OF CAPITAL AND NATIONAL DIRECT TAXATION MEASURES**

### **1. NON-DISCRIMINATION VERSUS NON-HINDRANCE TESTS?**

Article 63 TFEU “prohibits all restrictions on capital” and the ECJ has found that the Article encompasses national measures which are 1) directly or indirectly discriminatory as well as 2) non-discriminatory but which substantially hinder access to the market. Much of the literature on the free movement of capital stresses the lack of clarity in the case law and, in particular, with regard to the delineation between these two forms of prohibition. In fact, the ECJ has not yet formulated a clear-cut standard pertaining to whether a national measure shall be assessed by means of a “non-discrimination test” or, on the contrary, a “non-hindrance test”.<sup>59</sup> In describing the ECJ’s unsystematic application of these tests, Hindelang states that the Court’s case law evidences an unorthodox “tendency to consider clearly discriminating national measures in terms of the non-hindrance test”.<sup>60</sup> In general, he states:

The Court, while certainly acknowledging that national measures that differentiate on the basis of nationality, residence, etc can constitute discrimination, fails to put forward reasoning of a more doctrinal nature on what constitutes direct and indirect discrimination. Moreover, it appears that the Court does not attempt seriously to delineate clearly the ‘non-discrimination’ from the ‘non-hindrance’ test.<sup>61</sup>

For example, the decision in *Verkooijen* marks not only the origin of the ECJ’s case law at the intersection of taxation and intra-EU capital movements, but is also a case where the Court utilized language signifying a form of non-hindrance test where the contested rule was simply

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<sup>58</sup> Case C-374/04 *Test Claimants in Class IV of the ACT Group Litigation v. Comm’rs of Inland Revenue* [2006] ECR I-11673 (Opinion of AG Geelhoed), para 39.

<sup>59</sup> L. Flynn (n 36), at 782; see also Hindelang (n 56), at 142.

<sup>60</sup> Hindelang (n 56), at 143.

<sup>61</sup> *Ibid*, at 161.

discriminatory.<sup>62</sup> Although the national provision at issue was clearly discriminatory with regard to dividends on shares deriving from another Member State, the Court utilized the language of the non-hindrance test in finding that the measure had a “dissuading” effect. Only during the justification phase of its ruling did the Court then consider the discriminatory nature of the provision at issue.<sup>63</sup> Indeed, the ECJ’s expansive approach to the free movement of capital has been said to mask a “more sober reality” that in the majority of its decisions, “it is old-fashioned discrimination analysis that operates behind the more dynamic language of deterrent and dissuasive effects”.<sup>64</sup>

Indeed, the ECJ’s jurisprudence at the intersection of free movement of capital and national direct taxation measures highlights the lack of clarity as to the “formula” for application of either a non-discrimination or non-hindrance test. While the ECJ has firmly entrenched its application of a non-hindrance test to nearly all non-taxation measures that fall within Article 63(1) TFEU,<sup>65</sup> the Court follows the established case law of the other Treaty freedoms by relying—in substance as opposed to language—almost exclusively on discrimination analysis to evaluate national direct taxation measures.<sup>66</sup> As will be evidenced in greater detail subsequently, much of the case law at the intersection of national direct taxation measures and the free movement of services and persons has been transposed in the ambit of free movement of capital (e.g., *Schumacker*).<sup>67</sup> Nevertheless, with regard to the preferred test in direct taxation cases, Koen Lenaerts has observed that the ECJ prefers utilizing an elaborate form of the non-discrimination test as opposed to a restriction-based approach.<sup>68</sup> Similarly, AG Kokott stresses that a general non-hindrance test is incompatible with direct taxation cases in that such an approach would lead to a legal paradigm in which every tax measure would necessitate evaluation under EU law.<sup>69</sup> Further, AG Geelhoed has stated that the concept of indistinctly

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<sup>62</sup> Case C-35/98 *Staatssecretaris van Financiën v. B.G.M. Verkooijen* [2000] ECR I-4071; Horsley (n 24), at 161;

<sup>63</sup> See *Verkooijen* (n 62); Hindelang (n 56), at 141.

<sup>64</sup> Horsley (n 24), at 173. See also Jukka Snell, ‘*Non-discriminatory Tax Obstacles in Community Law*’, *International and Comparative Law Quarterly* 56, no. 2 (2007), pp 349-58.

<sup>65</sup> See, inter alia, *Commission v Portugal* (n 55).

<sup>66</sup> See, inter alia, Case C-279/93 *Finanzamt Köln-Altstadt v. Schumacker* [1995] ECR I-225; Horsley (n 24), pp 164-65.

<sup>67</sup> See notes 73-82 and the accompanying text.

<sup>68</sup> Sjoerd Douma, ‘*Non-discriminatory Tax Obstacles*’ 21 *EC Tax Review*, Issue 2 (2012), at 67; Koen Lenaerts, ‘*Federalism and the Rule of Law: Perspectives from the European Court of Justice*’, *Fordham International Law Journal* 33 (2011), at 1365-1366.

<sup>69</sup> Douma (n 68), at 67; Case C-498/10 X [2012] ECR I-0000, (Opinion of AG Kokott), para 28.



applicable “restrictions” of freedom of movement cannot legitimately be transposed per se to the direct tax sphere.<sup>70</sup> Indeed, Snell points out that despite a terminological shift in 1997 (albeit in an establishment case)<sup>71</sup> from discrimination- to restriction- or obstacle-based language in its direct taxation jurisprudence, it is clear that the Court continues to depend in reality on a more restrained, discrimination-based approach.<sup>72</sup>

The establishment of discrimination requires that “the capital movement that is affected by the national measure and the capital movement that is not, in objective terms, are both placed in comparable circumstances”.<sup>73</sup> More specifically, discrimination can only be present where the Court determines that there is either 1) unequal treatment of similar or comparable situations or 2) equal treatment of differing or incomparable situations.<sup>74</sup> Unfortunately, the ECJ is yet to provide a coherently articulated standard for what particular attributes or circumstances establish “comparability”.<sup>75</sup> According to Hindelang:

[It] is clear that the two capital movements to be compared need not and cannot be identical, but must be comparable in certain essential attributes... No general test exists to identify these “essential attributes”, but they are determined on a case-by-case basis. The “essential attributes” must be deduced primarily from actual circumstances and conditions, against the background of the purpose and content of the respective national measure, and under consideration of the value-based decisions stipulated by the Community legal order.<sup>76</sup>

Specifically, the sets of capital movements that are compared by the ECJ include both cross-border with domestic as well as cross-border with cross-border.<sup>77</sup> Consequently, one’s tax base as a byproduct of a taxpayer’s (non-)residency in a particular Member State is the most likely “essential attribute” to establish comparability. Following tax base, other attributes most frequently utilized by the Court to establish comparability include the nature of the taxpayer’s

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<sup>70</sup> Douma (n 68), at 67; Case C-524/04 *Test Claimants in the Thin Cap Group Litigation v Commissioners of Inland Revenue* [2007] ECR I-2107 (Opinion of AG Geelhoed), para 48.

<sup>71</sup> Case C-250/95 *Futura Participations* [1997] ECR I-2471

<sup>72</sup> Snell (n 64), pp 349-50.

<sup>73</sup> Hindelang (n 56), at 143.

<sup>74</sup> *Ibid*, pp 129-30; *Schumacker* (n 66), para 30; Case C-431/01 *Mertens v. Belgium* [2002] ECR I-7073, para 32 (holding “it is settled case law that there is unequal treatment when two categories of persons, whose factual and legal circumstances are not fundamentally different, are treated differently and when situations which are not comparable are treated in the same way”).

<sup>75</sup> Ruth Mason, ‘*Flunking the ECJ’s Tax Discrimination Test*’, 46 *Colum. J. Transnat’l L.* 72 (2007), at 22.

<sup>76</sup> Hindelang (n 56), at 144; Case C-418/07 *Societe Papillon* [2008] ECR I-8947, para 27; Case C-231/05 *Oy AA* [2007] ECR I-6373, para 38.

<sup>77</sup> *Ibid*, at 130.

economic activity as well as the portion of income sourced in the taxing host state.<sup>78</sup> Practically speaking, the seminal holding in *Schumacker* that “[i]n relation to direct taxes, the situations of residents and of non-residents are not, as a rule, comparable”<sup>79</sup> is indicative of the longstanding custom of international tax law that resident and non-resident taxpayers are nearly always subject to differing tax bases.<sup>80</sup> Generally, while residents are taxable by their home state on their worldwide income, non-residents are only taxable on income sourced in the host state.<sup>81</sup> Still, regardless of different tax bases, the ECJ often finds resident and non-resident taxpayers to be comparable. Conversely, “[j]ust as differences in the tax base [have] not always lead to the conclusion that the internal and cross-border situation were dissimilar, similarities in tax base did not inevitably lead to the conclusion that tax situations were similar”.<sup>82</sup>

The standard in *Schumacker* as to comparability, coupled with the standard’s inconsistent application across the Court’s tax jurisprudence, exemplifies the basic tension between EU free movement law and tax law. While an essential principle of the ECJ’s case law on free movement holds that differential treatment of residents and non-residents constitutes indirect discrimination on the grounds of nationality, the traditional premise of national and international tax law is that nationality and residence are perfectly acceptable distinguishing criteria.<sup>83</sup> In fact, the foundational approach to establishing jurisdiction over matters of taxation is based on the principle of territoriality which, accordingly, “refers to jurisdiction over persons, matters and things within the geographical boundaries of a State”.<sup>84</sup> Consequently, Wattel describes the tension between EU free movement law and tax law as a “struggle between...two in principle irreconcilable positions of allowing Member States to protect their taxing jurisdiction as defined by them, and at the same time prohibiting them to tax cross-border positions less favorably than

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<sup>78</sup> Mason (n 75), at 31.

<sup>79</sup> *Schumacker* (n 66), para 36.

<sup>80</sup> Mason (n 75), at 31.

<sup>81</sup> *Ibid*; see also Ruth Mason and Michael S. Knoll, ‘*What Is Tax Discrimination?*’, 121 *Yale L.J.* 1014 (2012), at 1027.

<sup>82</sup> Mason (n 75), at 31, citing to Case C-446/03, *Marks & Spencer plc v. Halsey* [2005] ECR I-10837 (where different tax bases did not exclude the possibility that parents of domestic subsidiaries and parents of foreign subsidiaries

would be considered comparable) and *D. v. Inspecteur van de Belastingdienst* (where similar tax bases did not lead to conclusion that taxpayers were comparable).

<sup>83</sup> Snell (n 22), pp 552-53.

<sup>84</sup> Sjoerd Douma, *Optimization of Tax Sovereignty and Free Movement* (2011), at 22, referring to Jeffries.

comparable [purely] domestic positions”.<sup>85</sup> Thus, seemingly, the ECJ’s “inconsistent” case law in direct taxation cases might simply be the understandable result of its role at the intersection of two contrary bodies of law. Still, within the ECJ’s analysis and determination of potential comparators, the Court’s process of comparison evidences more specific layers of inconsistency.<sup>86</sup> For example, the ECJ often compares only the factual circumstances of resident and non-resident taxpayers.<sup>87</sup> In other cases, for example in *Royal Bank of Scotland and Saint-Gobain*, the only point of comparison was the legal situation of the potential comparators.<sup>88</sup> Further, in other cases the Court has stated directly that comparability can only exist where factual circumstances are considered in light of a legal rule.<sup>89</sup>

The legal uncertainty spawned by the ECJ’s inconsistent approach to identifying comparators in its tax discrimination jurisprudence is reinforced by what is often described as a sheer lack of transparency as to the Court’s case-by-case reasoning. Mason holds the ECJ’s tax discrimination jurisprudence “to be arbitrary, ungrounded, and overly formalistic”.<sup>90</sup> Further, she states that the non-transparent formality of the non-discrimination test as applied to direct taxation enables the Court to strategically select comparators and retain the competence to classify virtually any national tax provision either as discriminatory or non-discriminatory.<sup>91</sup> With regard to this non-transparent formalism in the context of the Court’s role within the framework of the Treaty, Maduro states:

[B]y presenting courts as merely the appliers of preexisting law, formal reasoning denies discretion, isolates judicial decisions from extra-legal considerations and confers upon those decisions an appearance of neutrality. Courts are thus distinguished from political bodies which exercise discretion for political reasons.<sup>92</sup>

Still, and as will be discussed in the following sub-section, the non-transparent formality of the non-discrimination test can often entail dubiousness where the Court must distinguish prohibited

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<sup>85</sup> Ibid, at 36 referring to Terra and Wattel (2008) pp 343-344.

<sup>86</sup> Hindelang (n 56), at 149.

<sup>87</sup> Ibid.

<sup>88</sup> Ibid, citing to Case C–311/97 *Royal Bank of Scotland plc v. Greece*, [1997] ECR I–2651, para 24; Case C-307/97 *Compagnie de Saint-Gobain, Zweigniederlassung Deutschland v Finanzamt Aachen-Innenstadt* [1999] ECR I-06161, para 48.

<sup>89</sup> Hindelang (n 56), at 149; see also *Marks & Spencer* (n 82), Opinion of AG Maduro, para 49.

<sup>90</sup> Mason (n 75), at 40.

<sup>91</sup> Ibid, at 41.

<sup>92</sup> Maduro (n 34), at 11.

discrimination from non-prohibited “disparities” stemming from the co-existence of overlapping national taxation measures that inevitably exist in cross-border movements.<sup>93</sup> Thus, the ECJ’s reliance on non-transparent formalism can be seen as an attempt to avoid the appearance of second-guessing democratic will or, as referred to earlier, the collective will(s) of the Member States.<sup>94</sup>

## 2. DISCRIMINATION VERSUS DISPARITY?

An inevitable consequence of the co-existence of the discrete national tax systems of the Member States is that disparities exist between the autonomous rules of these jurisdictions.<sup>95</sup> Within the ambit of cross-border economic activity, these disparities are capable of manifesting as tax disadvantages (e.g., juridical double taxation). Still, not all disparities that result in cross-border tax disadvantages amount to a violation of the non-discrimination principle.<sup>96</sup> For example, if Ireland treats capital gains more favorably than Germany and an Irish citizen subsequently faces less favorable capital gains treatment on a cross-border investment in Germany, such a situation is generally not considered by the ECJ to be discriminatory. While such disparate tax treatment inevitably distorts cross-border investment decisions, the ECJ has specifically held that the Treaty offers no guarantee to an EU taxpayer that economic activity between two or more Member States will be neutral with regard to taxation.<sup>97</sup> In fact, the Court has consistently held that the free movement provisions are not concerned with any disparities in tax treatment which result from the overlapping or concurrent taxation of a single item of income by multiple Member States.<sup>98</sup>

The inevitability of concurrent direct taxation is due to the traditional, international tax paradigm in which both residence (home) and source (host) states have the right to tax.<sup>99</sup> Allocation of taxing rights within the ambit of concurrent taxation is coordinated through either

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<sup>93</sup> See Ruth Mason, ‘*Made in America for European Tax: The Internal Consistency Test*’, 49 B.C. L. REV. 1277 (2008).

<sup>94</sup> Mason (n 75), at 40.

<sup>95</sup> Douma (n 84), at 24; *Test Claimants in Class IV of the ACT Group Litigation v. Comm’rs of Inland Revenue* (n 58), Opinion of AG Geelhoed, para 43.

<sup>96</sup> See, inter alia, Case C-403/03 *Schempp v. Finanzamt München* [2005] ECR I-6421, para 34.

<sup>97</sup> Case C-365/02 *In re Lindfors* [2004] ECR I-7183, para 34.

<sup>98</sup> *Schempp* (n 96), para 34; see also Case C-336/96 *Gilly v. Directeur des Services Fiscaux du Bas-Rhin*, [1998] ECR I-2793, paras 49, 53.

<sup>99</sup> Mason (n 93), at 1288.

1) self-imposed unilateral limitations on jurisdiction initiated by the Member States or 2) DTCs.<sup>100</sup> Generally, the purpose of a DTC is to avoid double taxation as well as to outline the methodology by which both Member States will, in parallel, “carve up” the tax revenue generated by cross-border income.<sup>101</sup> Within this framework of concurrent taxation, the ECJ has been forced to determine whether a mere tax disparity with a resultant net tax disadvantage to a taxpayer is, in fact, the result of a particular Member State’s discriminatory measure. Conversely, the ECJ is confronted by situations where a tax disparity with a resultant net tax advantage to a taxpayer, in fact, obscures the discriminatory measure of a particular Member State.<sup>102</sup> Indeed, distinguishing cross-border tax disadvantages that are a result of disparities from those resulting from discrimination has proven to be a complicated task for the ECJ which has been marked by mixed results.<sup>103</sup>

Triangular or multi-angular tax situations can further muddle the ECJ’s distinctions between disparities and discrimination. For example, in *De Groot*, a Dutch national and resident earned most of his income in the Netherlands but some of it was sourced in three other Member States.<sup>104</sup> Dutch tax law utilized a “proportionality method” (*pro rata parte*) which allowed for personal deductions only in proportion to the taxpayer’s Dutch-source income.<sup>105</sup> In that the other three Member States did not utilize a parallel, coordinated proportionality method and were under no obligation to offer a non-resident any deductions whatsoever,<sup>106</sup> the taxpayer’s deductions were taken into account far less than would have been the case in a purely domestic situation. While the taxpayer argued that the tax disadvantage was discriminatory, the Netherlands government held that the tax disadvantage was simply the result of disparities between its tax system and those of the other Member States at issue.<sup>107</sup> In rejecting the argument of the Netherlands government, the ECJ relied on its ruling in *Schumacker* to hold that the residence Member State has the primary responsibility to afford personal tax benefits such as

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<sup>100</sup> Douma (n 84), at 23.

<sup>101</sup> Mason (n 93), at 1288-89.

<sup>102</sup> Dennis Weber, *In Search of a (New) Equilibrium Between Tax Sovereignty and the Freedom of Movement Within the EC*, 34 *Intertax* (2006), at 588; see also Mason (n 93), at 1290.

<sup>103</sup> Mason (n 93), at 1293.

<sup>104</sup> Case C-385/00, *De Groot v. Staatssecretaris van Financiën* [2002] ECR I-11819, paras 27-29.

<sup>105</sup> *Ibid*, para 18.

<sup>106</sup> See *Schumacker* (n 66) where the ECJ held that a host Member States could deny personal tax benefits to a non-resident if the non-resident did not earn all or almost all her income in said host state.

<sup>107</sup> *De Groot* (n 104), paras 57, 85.

deductions in cross-border economic activity. This responsibility is based on the—possibly outdated—assumption that a taxpayer will earn most of his income in his state of residence.<sup>108</sup> Either way, while the Court held the Dutch proportionality method to be discriminatory (as opposed to a mere disparity), the Court actually utilized language of the non-hindrance test in stating that the measure “discouraged” the taxpayer from taking up employment in another Member State.<sup>109</sup> Further, in that the Netherlands government had relied on the ECJ’s holding in *Gilly* that higher taxation in a cross-border tax situation due to tax rate disparities is not discriminatory, the Court summarily distinguished the cases in that the “tax disadvantage suffered by Mr de Groot is in no way...the result of the difference between the tax rates of the State of residence and those of the States of employment”.<sup>110</sup>

Instead, the ECJ in *De Groot* relied on both *Schumacker* and *Gilly* to hold that the Dutch *pro rata parte* method of taxation was, in itself, discriminatory and thus contrary to Community free movement law. In fact, as Lang points out, “[r]eaders of the Opinion of Advocate General Léger are given the impression that the case of the ECJ was all too obvious on this issue”.<sup>111</sup> In fact though, the Court’s ruling was delivered as such despite the actuality that neither *Schumacker* nor *Gilly* provided an unambiguous answer as to whether the loss of personal deductions due to the application of the *pro rata parte* method was indeed discriminatory.<sup>112</sup> While a systematic application of the ECJ’s decisions in *Schumacker* and *Gilly* does indeed support the holding that the Netherlands was under an obligation to take account of the total personal deductions applicable in its jurisdiction (in that the Netherlands was the Member State of residence and the majority of the taxpayer’s income was earned there),<sup>113</sup> a closer comparison of *Gilly* and *De Groot* demonstrates that these decisions are fundamentally inconsistent.<sup>114</sup> In citing to the observations of Wattel, Lang stresses that in *Gilly*, “it appears that the ECJ was not aware of the fact that the [Member] State of residence (France) applied the *pro rata parte* method” and that, in fact, *Gilly* “raised the same issue as *De Groot*”.<sup>115</sup> Both cases featured

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<sup>108</sup> See *Schumacker* (n 66).

<sup>109</sup> *De Groot* (n 104), para 84.

<sup>110</sup> *Ibid*, para 86.

<sup>111</sup> Michael Lang, *Direct Taxation: Recent ECJ Developments* (Kluwer Law International, 2003), at 177.

<sup>112</sup> *Ibid*, at 176.

<sup>113</sup> See *Schumacker* (66).

<sup>114</sup> M. Lang (n 111), 177-78.

<sup>115</sup> *Ibid*.

national direct taxation measures which caused net tax disadvantages within the context of DTCs. But, in *Gilly*, the Court failed entirely to take notice of national taxation measures in France which also utilized a *pro rata parte* method and which had the effect of 1) decreasing host-state deductions by 55% and 2) completely nullifying all home-state deductions.<sup>116</sup> Thus, in *Gilly*—as opposed to *De Groot*—the Court held that the net tax disadvantage was simply the result of disparities in the natural course of cross-border economic activity.<sup>117</sup>

The Court’s reliance on “the *Schumacker* doctrine” to single-out the Dutch *pro rata parte* method as opposed to national measures of other Member States with similar design and effects illustrates that the non-transparent formality of the Court’s decisions sometimes results in decisions that appear arbitrary or unfounded. Effectively highlighting the dubious reasoning behind the Court’s distinction between discrimination and disparity in the context of concurrent taxation, Mason states:

[I]f the other countries employed the proportionality method, De Groot could, in sum, be entitled to more personal tax benefits than if he had income only in the Netherlands. He could also be entitled to less. Whether De Groot would come out ahead or behind (as compared to a Dutch resident with only Dutch-source income) would depend on the amount of personal [deductions] offered by Germany, France, and the United Kingdom.<sup>118</sup>

In fact, the above hypothetical refers to an essential and unsettled issue of whether the ECJ—as a part of its “formula” for delineating between discrimination and disparity—should consider a Member State’s measure 1) in isolation (the “per-country approach”) or 2) in comparison to the measures of other Member States with which the measure in question is supposed to be coordinated (the “overall approach”).<sup>119</sup> The two approaches are incompatible with each other and have been utilized by the Court at different times.<sup>120</sup> For example, in *Eurowings*, the Court utilized the per-country approach to hold that a Member State may not justify tax discrimination on the grounds that the taxpayer is subject to lower taxation or “positive” concurrent tax treatment in another Member State.<sup>121</sup> Differently, and as will be discussed at length in the

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<sup>116</sup> Ibid.

<sup>117</sup> Ibid.

<sup>118</sup> Mason (n 75), at 19.

<sup>119</sup> See Weber (n 102), at 599.

<sup>120</sup> Ibid, pp 599-606.

<sup>121</sup> Case C-294/97 *Eurowings Luftverkehrs AG v. Finanzamt Dortmund-Unna* [1999] ECR I-7447, para 43-44.

following section, in *Manninen* the ECJ utilized the overall approach and thus considered—in its entirety—the tax paradigm established by the concurrent taxation measures of the differing Member States.<sup>122</sup> While these opposing approaches might understandably be specifically applicable to particular tax situations, Mason stresses that “the Court has offered no explanation for why it vacillates between the approaches, and, indeed, it has never explicitly acknowledged that it has adopted different approaches in different cases”.<sup>123</sup> She observes further that the application of the overall approach is hardly consistent in itself considering the Court “sometimes analyzes the actual law of the other Member States involved, but at other times it speculates about what the other State’s law might be and decides the case based on those assumptions”.<sup>124</sup>

Regardless of the actual effectiveness of the per-country and overall approach with regard to distinguishing accurately between discrimination and disparity, AG Geelhoed has stated his preference for the overall approach.<sup>125</sup> Specifically, he stresses that only the overall approach enables concurrent taxation measures to be seen within the context of their co-existence or “be seen as a whole, or as achieving a type of equilibrium”.<sup>126</sup> Dissimilarly, while the per-country approach is capable of deciphering those national taxation measures which are discriminatory on their face, said approach is not capable of an accurate examination of the myriad autonomous taxation measures that inevitably interact with each other through cross-border economic activity.<sup>127</sup> But, in that the overall approach necessitates the comparison (and judgment) of the legislation of various Member States, the overall approach can be said to erode Member State tax sovereignty.<sup>128</sup> Further, as numerous commentators have pointed out, the overall approach raises the question of whether the ECJ is actually capable of such an examination. To define and decipher an entire paradigm of interacting, concurrent taxation measures is quite problematic in that 1) the ECJ is not comprised of experts in taxation and 2) the comparison of multiple concurrent national taxation measures (both real and hypothetical) inevitably leads to legitimate

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<sup>122</sup> See Mason (n 93), at 1304; *Manninen* (note 24 above) para 54; see also *Marks & Spencer* (n 82) para 55.

<sup>123</sup> Mason (n 93), at 1305.

<sup>124</sup> *Ibid.*

<sup>125</sup> *Test Claimants in Class IV of the ACT Group Litigation v. Comm’rs of Inland Revenue* (n 58), Opinion of AG Geelhoed, para 72.

<sup>126</sup> *Ibid.*

<sup>127</sup> Mason (n 93), at 1306.

<sup>128</sup> Weber (n 102), pp 602-03.



issues of legal certainty.<sup>129</sup> Nevertheless, while AG Geelhoed famously presented his generalization in *ACT Group Litigation* that the key feature distinguishing disparity from discrimination is that discrimination “occur[s] as the result of the rules of just one tax jurisdiction”,<sup>130</sup> this statement fails to address the situation that nearly *all* cross-border economic activity in the EU entails the concurrent tax jurisdiction of at least two Member States.<sup>131</sup> Clearly, not all concurrently applicable national taxation measures are non-discriminatory. And, despite copious analysis of ECJ case law, the fact remains that regardless of what standard(s) the Court utilizes to determine whether national taxation measures entail discrimination or disparity, “overlapping taxation as a structural feature of international taxation tends to obscure the presence of discrimination in some cases and to suggest its presence where there is none in other cases”.<sup>132</sup>

## **PART IV — SANDOZ, MANNINEN, KERCKHAERT: AN ABANDONED FORAY INTO THE REALM OF DIRECT TAXATION MEASURES**

### **1. THE GROUNDWORK**

As mentioned earlier, the ECJ for a brief time appeared willing to apply the full weight of the non-hindrance test to its case law at the intersection of national direct taxation measures and the free movement of capital.<sup>133</sup> In *Sandoz*, the Court reviewed a non-discriminatory measure in the form of an Austrian stamp duty of 0.8 percent applicable to loans obtained by resident taxpayers in Austria. The tax was imposed on loans regardless of whether the provider of the loan was established in Austria or another Member State. Further, the tax was applicable regardless of the nationality of the resident that obtained the loan.<sup>134</sup> The Court followed the Opinion of AG Léger in holding that the required tax on loans contracted on a cross-border basis (outside Austria) was a “restriction” on the free movement of capital in that it “deprive[d] residents of a Member State of the possibility of benefiting from the absence of taxation which may be

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<sup>129</sup> Mason (n 93), at 1306.

<sup>130</sup> *Test Claimants in Class IV of the ACT Group Litigation v. Comm’rs of Inland Revenue* (n 58), para 46.

<sup>131</sup> Weber (n 102), at 588, Mason (n 93), pp 1299-1300.

<sup>132</sup> Mason (n 93), at 1300.

<sup>133</sup> See notes 23-28 and 50-57.

<sup>134</sup> See *Sandoz* (n 24).

associated with loans obtained outside the national territory...[and that] such a measure [was] likely to deter such residents from obtaining loans from persons established in other Member States”.<sup>135</sup> Again, while the Court’s case law has at times displayed the language of the non-hindrance test in striking down Member State measures that are actually discriminatory,<sup>136</sup> in *Sandoz* the ECJ appears to have relied on the actual substance of the disputed measure.<sup>137</sup> In describing the apparently paradigm-shifting result of the decision, Horsley explains:

The Court’s decision obliged the Austrian State to justify, under EU law, its decision not to adjust its non-discriminatory tax rules to preserve, for resident taxpayers, an advantage arising through “disparities” between different tax regimes within the Union.<sup>138</sup>

Still, regardless of the fact that the Court boldly utilized a non-hindrance test in holding the substance of a non-discriminatory direct taxation measure to be a restriction of free movement, both Horsley and Snell—among others—stress that the Court’s treatment of the Austrian measure at the justification-phase of the proceeding was most generous.<sup>139</sup> In fact, Snell states that the Court’s standard for justification in *Sandoz* implies that the Court “would permit essentially all equally applicable national tax rules”.<sup>140</sup> Indeed, while Horsley considers *Sandoz* to represent “the high-water mark” at the intersection of national direct taxation and the free movement of capital, Snell holds that the decision in the case should be weighted with “considerable caution” in light of the Court’s leniency as to the Austrian justification.<sup>141</sup>

Differently, yet using identical language, Snell considers *Manninen* to represent “the high-water mark” of the Court’s application of the non-hindrance test at the intersection of direct taxation and the free movement of capital.<sup>142</sup> In this case, as mentioned in Part I, AG Kokott explicitly held in her opinion that even within the ambit of national direct taxation measures, “the concept of a restriction of capital movements corresponds to the concept of a restriction that the

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<sup>135</sup> Ibid, para 19.

<sup>136</sup> See, inter alia, *Verkooijen* (n 62), para 34.

<sup>137</sup> See Horsley (n 24), pp 161-65.

<sup>138</sup> Ibid, at 165.

<sup>139</sup> Ibid; see also Snell (n 22), at 557.

<sup>140</sup> Snell (n 22), at 557.

<sup>141</sup> Horsley (n 24), at 165; Snell (n 22), at 557.

<sup>142</sup> Snell (n 22), at 557.

Court has developed with regard to the other fundamental freedoms”.<sup>143</sup> The direct taxation measure at issue was a method by which the Finnish government taxed Finnish resident taxpayers on dividends distributed by Finnish companies. The Finnish system taxed these purely domestic dividend distributions *twice*; a corporate tax was applied when the company earned the profits and income tax was applied to the same item of income when it had been distributed to the resident shareholder.<sup>144</sup> Thus, Finland granted tax credits to resident shareholders of domestic companies in order to relieve the burden of economic double taxation on corporate profits. In fact, this system guaranteed that resident taxpayers receiving dividends from Finnish companies did not suffer tax treatment on the dividends in excess of the Finnish income tax rate of 29 percent.<sup>145</sup> Dissimilarly, such credits were not made available to Finnish resident taxpayers on dividends distributed by companies located in other Member States in that 1) Finland only taxed foreign profits / dividends *once* in the form of income tax applicable to the shareholder upon distribution and 2) Finland was not responsible for the existence of economic double taxation on dividends distributed by companies outside of its taxing jurisdiction.<sup>146</sup>

Manninen was a shareholder in a Swedish company that distributed a dividend on which he was responsible to pay income tax in Finland. Manninen was subsequently denied the aforementioned tax credits and thus argued that the Finnish taxation measure was discriminatory.<sup>147</sup> Finland defended its taxation measure on the ground that the capital movement at issue—an inbound corporate profit distribution—was not comparable to purely domestic profit distributions in that Finland did not subject inbound distributions to either corporate taxation or economic double taxation.<sup>148</sup> Still, in utilizing the overall approach, the ECJ determined that the inbound corporate profit distribution had been subjected both to Swedish corporate taxes and economic double taxation.<sup>149</sup> Further, based on the taxpayer’s subjection to economic double taxation, the Court held that this capital movement in the form of an inbound corporate profit

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<sup>143</sup> *Manninen* (n 24), Opinion of AG Kokott, para 28.; see also note 25 and the corresponding text.

<sup>144</sup> *Manninen* (n 24), paras 27, 30.

<sup>145</sup> See *Weber* (n 102), at 597.

<sup>146</sup> *Manninen* (n 24), para 30.

<sup>147</sup> *Ibid*, paras 12-14.

<sup>148</sup> *Ibid*, paras 26-27.

<sup>149</sup> *Ibid*, paras 12-13.

distribution was, in fact, comparable to a purely domestic situation.<sup>150</sup> Specifically, the Court stated:

Where a person fully taxable in Finland invests capital in a company established in Sweden, there is thus no way of escaping double taxation of the profits distributed by the company in which the investment is made. In the face of a tax rule which takes account of the corporation tax owed by a company in order to prevent double taxation of the profits distributed, shareholders who are fully taxable in Finland find themselves in a comparable situation, whether they receive dividends from a company established in that Member State or from a company established in Sweden.<sup>151</sup>

However, regardless of the above discrimination-based analysis, the aggressiveness of the Court's decision in *Manninen* is exemplified by the explicit use of not only the language but, seemingly, the substance of the non-hindrance test.<sup>152</sup> In light of AG Kokott's promotion of a broad definition of the concept of a restriction of capital movement<sup>153</sup> and the Court's citing to *Verkooijen*, the ECJ held that the Finnish direct taxation legislation had the effect of "detering" fully taxable persons in Finland from investing their capital in companies established in another Member State.<sup>154</sup> Further, the measure at issue was held to make cross-border shareholdings "less attractive" to investors residing in Finland.<sup>155</sup>

While *Manninen* is representative of ECJ's progressive "application of the full force of the internal market law in the field of taxation", this decision and its immediately preceding case law inspired much uneasiness and a large range of critical analyses from both the Member States as well as the international tax law community.<sup>156</sup> With regard to the Finnish taxation measure in *Manninen*, Weber—among many others—stresses that the ECJ failed to properly distinguish between discrimination and mere disparity within the context of the non-discrimination test.<sup>157</sup> In fact, Weber's criticism entails little to no recognition of the possibility that the non-hindrance test was influential on the Court aside from a brief acknowledgment that the Court made "a

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<sup>150</sup> Ibid, paras 54-55.

<sup>151</sup> Ibid, para 36.

<sup>152</sup> Ibid, paras 22-23.

<sup>153</sup> *Manninen* (n 24), Opinion of AG Kokott, para 28.

<sup>154</sup> Ibid.

<sup>155</sup> Ibid.

<sup>156</sup> Snell (n 22), pp 552-53.

<sup>157</sup> See Weber (n 102), pp 597-98.

reference to decisions like *Verkooijen*".<sup>158</sup> Rather, Weber appears to utilize a per-country approach to describe the particular Finnish direct taxation measure as merely a taxation system or "method" by which Finland exercised its sovereignty to tax profits once they enter Finland's tax jurisdiction.<sup>159</sup> He describes the Finnish system as 1) completely logical, 2) non-discriminatory in both principle and practice, and 3) simply disparate from the many other methods that can be utilized to ensure that a shareholder's income is only subject to income tax—as opposed to economic double taxation.<sup>160</sup> Quite scathingly, Weber stresses that "[n]ot crediting foreign corporation tax is a [net tax] disadvantage that arises because several Member States are exercising their sovereignty to levy tax (disparity) and it is not the consequence of a discriminatory tax system in one Member State".<sup>161</sup>

The ECJ's difficulty in distinguishing between discrimination and disparity, coupled with its apparent attempt to include non-discriminatory direct taxation measures within the ambit of its restriction-based jurisprudence, combined to threaten the balance of power between the Member States and the Union as to the overall regulation of the internal market. Specifically, the potential inclusion of non-discriminatory direct taxation measures within the ECJ's ever-broadening definition of the free movement of capital was seen as a direct assault on the sovereign right of the Member States to raise tax revenue in support of their economic and social policies.<sup>162</sup> As Horsley articulately summarizes:

If the ECJ opts to define the scope of the Treaty freedoms broadly, it thereby increases its own power of review over the substantive policy preferences of the Member States in this area of shared competence. By contrast, a narrower approach operates to immunize a greater body of national law from scrutiny against the Treaty framework. There is as yet no consensus on how to strike the appropriate balance between Union and Member State competence in this context and the issue remains hotly contested.<sup>163</sup>

The ECJ's decision in *Kerckhaert* is considered to be an abrupt and decisive change of course from what had become a most controversial line of cases. Still, *Kerckhaert* is considered neither

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<sup>158</sup> *Ibid*, at 597.

<sup>159</sup> *Ibid*, pp 597-98.

<sup>160</sup> *Ibid*.

<sup>161</sup> *Ibid*, at 598.

<sup>162</sup> Melchior Wathelet, 'The Influence of Free Movement of Persons, Services and Capital on National Direct Taxation: Trends in the Case Law of the Court of Justice' (2001) 20 YEL, at 1.

<sup>163</sup> Horsley (n 24), at 159.

to be indisputable in its reasoning nor a decision which facilitated any reconciliation or balancing of the inherent conflict between national direct tax sovereignty and free movement. In fact, it can be said that the decision may have had the opposite effect of reconciliation.

## 2. KERCKHAERT & MORRES

Before the ECJ's decision in *Kerckhaert* and in light of the progressive line of cases just described which culminated with *Manninen*, a vast number of scholars as well as the European Commission expressed the position that "Member States are bound by the Treaty principle of free movement within the Community to avoid and eliminate double taxation".<sup>164</sup> Further, three years before the ECJ's decision in *Kerckhaert*, the Commission explicitly argued that higher taxation of cross-border dividends should be deemed a restriction in violation of the free movement of capital.<sup>165</sup> In fact, because of a "growing consensus" that double taxation was in contravention of the Treaty freedoms, academic discussion quite presumptuously transferred to the follow-up questions of whether the residence (home) or source (host) Member State should have the obligation to relieve said double taxation and which particular method of relief would be best-suited for that purpose.<sup>166</sup> Thus, there was an element of surprise when AG Geelhoed's subsequent opinions in both *ACT Group Litigation*<sup>167</sup> as well as *Kerckhaert*<sup>168</sup> defined double taxation as mere a "quasi-restriction" or a net tax disadvantage resulting from disparities present in the concurrent application of the tax systems of multiple Member States.<sup>169</sup> Harkening back to the Court's rigid utilization of the language and substance of the non-discrimination test, in *Kerckhaert* the ECJ 1) attempted to distinguish cases such as *Manninen* on the basis of the substance of the national measure at issue, 2) utilized discrimination analysis to evaluate the legality of identical tax treatment to allegedly incomparable situations under EU free movement

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<sup>164</sup> Response from Commissioner Bolkestein on behalf of the Commission to Written Question E-2287/99 by Karin Riis-Jorgensen (ELDR) to the Commission with regard to the "Right to freedom of movement and Danish tax rules", 2000 O.J. (C 225) 87.

<sup>165</sup> *Communication from the Commission to the Council, the European Parliament and the European Economic and Social Committee, Dividend Taxation of Individuals in the Internal Market*, COM (2003) 810 final (Dec. 19, 2003); Georg W. Kofler & Ruth Mason, 'Double Taxation: A European "Switch in Time?"', 14 Colum. J. Eur. L. 63 (2007), at 77.

<sup>166</sup> Kofler & Mason (n 165), at 77.

<sup>167</sup> *Test Claimants v. Comm'rs of Inland Revenue* (n 58), para 48.

<sup>168</sup> *Kerckhaert & Morres* (n 22), para 31.

<sup>169</sup> Kofler & Mason (n 165), at 74.

law and, finally, 3) addressed the existence net tax disadvantages caused by disparities arising from multiple Member States' parallel exercise of fiscal / tax sovereignty.<sup>170</sup>

In *Kerckhaert*, Belgian taxpayers received dividends from Eurofers SARL—a company established in France—and, per the provisions of the Belgian-French DTC, France imposed a 15% withholding tax on the dividends before their cross-border distribution. When these taxpayers eventually included the profit from the dividends as a part of their personal income tax return in Belgium, Belgium assessed an additional tax of 25% and did not credit or “impute” the French withholding tax.<sup>171</sup> While the taxpayers considered this tax treatment to be a violation of the DTC, the Belgian national courts ruled otherwise.<sup>172</sup> Moreover, even though the aforementioned imputation method was not utilized, the French tax was nonetheless taken into account by the Belgian tax authorities in the form of a deduction from a taxpayers' tax base in Belgium.<sup>173</sup> Still, and despite the fact that the Belgian tax was assessed equally to both domestic and cross-border dividends, the combination of the French withholding tax and the Belgian refusal to impute said withholding tax resulted in a higher tax burden for cross-border dividends.<sup>174</sup> In light of the ECJ's previous rulings with regard to equal tax treatment of differing or incomparable situations,<sup>175</sup> the Belgian national court requested a preliminary ruling as to whether what is now Article 63 must be:

interpreted as prohibiting a restriction resulting from a provision in the income tax legislation of a Member State... which subjects dividends from resident companies and dividends from companies resident in another Member State to the same uniform tax rate, without in the latter case providing for the setting off of tax levied at source in that other Member State[.]<sup>176</sup>

Consequently, while the request stemmed merely from a Belgian direct taxation measure in the context of a DTC, the more far-reaching legal question at issue in *Kerckhaert* was whether juridical double taxation was a breach of the free movement of capital.<sup>177</sup>

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<sup>170</sup> Ibid, pp 74-79; Snell (n 22), pp 558-63; Snell (n 64), pp 358-66.

<sup>171</sup> *Kerckhaert & Morres* (n 22), paras 3-12.

<sup>172</sup> Ibid.

<sup>173</sup> Kofler & Mason (n 165), pp 75-76.

<sup>174</sup> Ibid.

<sup>175</sup> See note 74 and the accompanying text.

<sup>176</sup> *Kerckhaert & Morres* (n 22), para 14.

<sup>177</sup> Kofler & Mason (n 165), at 76.

The Court’s decision was quite brief and its discrimination analysis hinged on an assessment of the comparability of capital movements and/or taxpayers.<sup>178</sup> In citing to both *Verkooijen* and *Manninen*, the Court referred to the fact that the Member State taxation measures at issue in those cases treated income generated from cross-border dividends differently than income generated from purely domestic dividends. More specifically, the direct taxation measures at issue in *Verkooijen* and *Manninen* were held to deny recipients of cross-border dividends the tax *benefits* granted to those shareholders receiving purely domestic dividends. Because in *Verkooijen* and *Manninen* the ECJ concluded that the situation of taxpayers receiving cross-border dividends was comparable to (or, at least “not objectively different from”) the situation of those taxpayers receiving domestic dividends, the Court held that the measures at issue amounted to discrimination.<sup>179</sup> Differently, while the Court in *Kerckhaert* cited to *Schumacker* and *Royal Bank of Scotland*<sup>180</sup> in conceding that discriminatory tax measures can consist of the application of the same rule to different or incomparable situations, the Court stressed that the situation of a taxpayer that receives cross-border dividends is not necessarily incomparable to the situation of a taxpayer that receives only domestic dividends.<sup>181</sup> Further, the Court held that—unlike the measures at issue in *Verkooijen* and *Manninen*—the substance of the contested Belgian tax legislation did not make any explicit distinction between cross-border and domestic dividends. Rather, both cross-border and domestic dividends were merely subjected to a uniform rate of income tax.<sup>182</sup> Thus, in the absence of sufficient evidence of an objective difference between the situations of the applicants and other resident taxpayers receiving dividend income only from companies established in Belgium, the ECJ held that the Belgian tax treatment did not amount to discrimination.<sup>183</sup> Finally, with regard to the Court’s delineation between discrimination and disparity, the difference in tax treatment of cross-border dividends was held to be merely the result of “the exercise in parallel by two Member States of their fiscal sovereignty”.<sup>184</sup>

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<sup>178</sup> See notes 73-82 and the accompanying text.

<sup>179</sup> *Kerckhaert & Morres* (n 22), para 16.

<sup>180</sup> *Schumacker* (n 66), at 30; *Royal Bank of Scotland* (n 88), at 26.

<sup>181</sup> *Kerckhaert & Morres* (n 22), para 18.

<sup>182</sup> *Ibid*, paras 17-18.

<sup>183</sup> *Ibid*, paras 16-19; see also *Horsley* (n 24), pp 162-63.

<sup>184</sup> *Kerckhaert & Morres* (n 22), para 20.



### 3. KERCKHAERT CRITICISM AND DEBATE

The lingering criticism and debate with regard to the above line of case law leads to the opinion that the ECJ's effort to delineate between discrimination and disparity is both dubious and a cause of legitimate legal uncertainty. For example, one of the ECJ's primary grounds for distinguishing *Kerckhaert* entailed the simple premise that while these earlier cases featured national measures which explicitly distinguished between cross-border and domestic dividends, the Belgian tax at issue was equally applicable to *all* dividends received by resident taxpayers.<sup>185</sup> Yet, as to this line of argument, Snell stresses that the distinction drawn between *Kerckhaert* and the earlier cases "is not sound" and was hardly "forced upon it by an inevitable Cartesian logic".<sup>186</sup> In fact, both *Verkooijen* and *Manninen* entail rulings in which ECJ appeared to utilize the overall approach to evaluate an entire tax paradigm comprised of the concurrent taxation measures of multiple Member States. Thus, both *Verkooijen* and *Manninen* can be read in conjunction as a requirement imposed on the Member States to recognize the concurrently applicable tax systems of *other* Member States.<sup>187</sup> In effect, the Court's ruling in *Manninen* entailed the "mutual recognition" of a foreign tax for the purpose of granting a tax credit.<sup>188</sup> Differently, the Court's ruling in *Kerckhaert* "emphatically denies" any requirement on the part of the Belgian government to recognize the concurrent taxation measure of France.<sup>189</sup> Thus, with regard to the applicability of a form of mutual recognition within the ambit of cross-border taxation, the ECJ has never made clear why such recognition is necessary—in particular instances—when a Member State grants a tax advantage (*Manninen*) but unnecessary when the Member State imposes a tax (*Kerckhaert*).<sup>190</sup> Similarly, beyond the cases of *Verkooijen* and *Manninen*, Kofler and Mason state that the ECJ's ruling in *Kerckhaert* abandons its mutual recognition jurisprudence as well as its prior jurisprudence on the double use of losses as exemplified by *Marks & Spencer*.<sup>191</sup> While the ruling in *Marks & Spencer* featured the principle of mutual recognition as a means to prevent EU taxpayers from utilizing tax losses to offset income in more than Member State, in *Kerckhaert* the Court appears to hold that mutual

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<sup>185</sup> Snell (n 22), at 558.

<sup>186</sup> *Ibid*, at 560.

<sup>187</sup> *Ibid*.

<sup>188</sup> *Ibid*; see also Snell (n 64), pp 361-62.

<sup>189</sup> Snell (n 22), at 560.

<sup>190</sup> *Ibid*; see also Snell (n 64), pp 361-62.

<sup>191</sup> Kofler & Mason (n 165), at 80; *Marks & Spencer* (n 82) para 47.

recognition of concurrent taxation measures is not required to protect taxpayers from juridical double taxation.<sup>192</sup> With regard to this inconsistent application of the principle of mutual recognition, Kofler and Mason stress that the Court’s decision in *Kerckhaert* “creates a striking asymmetry” which is arguably quite unacceptable to the functioning of the internal market.<sup>193</sup>

Nevertheless, to be clear, Snell certainly recognizes the possibility that the logic whereby dual burdens are evaluated in light of the principle of mutual recognition<sup>194</sup> can be neither 1) transposed fully within the ambit of national direct taxation measures, nor 2) applied to double taxation.<sup>195</sup> While Vanistendael is of the opinion that the principle of mutual recognition—as established by the ECJ’s non-taxation case law—can and should be applied to Member State direct taxation measures,<sup>196</sup> those such as Weber stress the need for a much more restrained approach.<sup>197</sup> Specifically, Weber states that to determine whether the principle of mutual recognition should be applied to a particular area of the law without infringing upon the sovereignty of the individual Member States, “one has to take into consideration the basic assumptions that are characteristic for this area of the law (object and purpose, general contours, substance in the various Member States) and the extent to which the national law is harmonized”.<sup>198</sup> In citing to *Heylens* and *Vlassopoulou* to highlight situations in which Member State sovereignty was held to be less important than particular harmonizing measures,<sup>199</sup> Weber explains:

Whether the unrestricted freedom of movement weighs more heavily than a breach of the sovereignty of the Member States will have to be considered. It is therefore no coincidence that the principle of mutual recognition is applied in particular in those areas in which sovereignty is not a pressing issue.<sup>200</sup>

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<sup>192</sup> Kofler & Mason (n 165), pp 80-81.

<sup>193</sup> Ibid, at 81.

<sup>194</sup> See *Cassis de Dijon* (n 52), para 8.

<sup>195</sup> Snell (n 64), at 365.

<sup>196</sup> See F. Vanistendael, ‘*The ECJ at the crossroads: balancing tax sovereignty against the imperatives of the single market*’, *European Taxation*, no. 9 (2006) at 419.

<sup>197</sup> Weber (n 102), at 591.

<sup>198</sup> Ibid.

<sup>199</sup> Case 222/86 *Heylens* [1987] ECR 4097; Case C-340/89 *Vlassopoulou* [1991] ECR I-2357.

<sup>200</sup> Weber (n 102), pp 591-92.

Moreover, Weber addresses the ECJ's ruling in *Gaston Schul*<sup>201</sup> and distinguishes the application of the principle of mutual recognition within the ambit of indirect taxation (VAT). While he acknowledges that it is "tempting to directly transpose the [ECJ's] solution in *Gaston Schul* to direct taxation", he stresses that the ruling was only made possible by the fact that the "object and purpose as well as the most important basic assumptions, general contours and substance of the VAT had [already] been harmonized".<sup>202</sup> He stresses that because direct taxation measures of the Member States lack any such level of harmonization, the ECJ's ruling in *Gaston Schul* specifically excludes said measures from subjection to the principle of mutual recognition.<sup>203</sup> Still though, and despite his evidencing the ECJ's cautious approach to the application of the mutual recognition to national direct taxation measures, Weber nonetheless concedes that "it is not yet clear to what extent the ECJ will apply the case law on...the principle of mutual recognition to cases involving national direct tax measures".<sup>204</sup>

Indeed, none of the above criticism or analysis changes the fact that the ECJ appears—randomly and only at times—to apply a form of mutual recognition in conjunction with its utilization of the overall approach to evaluate Member State direct taxation measures. Conversely, as is the case in *Kerckhaert*, the language and substance of the Court's rulings sometimes appear to disregard the recognition of "other" concurrent taxation measures altogether and to evaluate direct taxation measures through strict application of the per-country approach. Consequently, due to the non-transparent formality of many of the ECJ's rulings with regard to direct taxation measures, whether the overall or per-country approach has actually been utilized is often difficult to decipher. In fact, despite AG Geelhoed's acknowledged preference for the overall approach for direct taxation cases, the Court's discrimination analysis in *Kerckhaert* is essentially void of any substantial analysis of the effect of the concurrent taxation measures' co-existence. Differently though, in his opinion preceding the Court's ruling in *Kerckhaert*, AG Geelhoed clearly engaged in a detailed consideration of the potential effects of the parallel application of the concurrent taxation measures.<sup>205</sup> Through his analysis of both the Belgian and

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<sup>201</sup> Case C-15/81 *Gaston Schul* [1982] ECR 1409.

<sup>202</sup> Weber (n 102), at 592.

<sup>203</sup> Ibid.

<sup>204</sup> Ibid, at 589.

<sup>205</sup> See Mason (n 93), pp 1296-97.

French measures, AG Geelhoed adopted a popular line of argument<sup>206</sup> which concluded that the Belgian taxpayers in *Kerckhaert* actually paid *less* tax on their cross-border dividends than would have been assessed in a purely internal situation.<sup>207</sup> Specifically, he stated “the actual effect of the operation of the French system was that Belgian-resident shareholders received a higher amount in the case of French-source dividends than in the case of exactly the same amount of dividends distributed from a Belgian company”.<sup>208</sup> Further, he concluded that “the actual (favourable) effect of the legislative framework for [the taxpayers] is in my view decisive on the facts of the present case”.<sup>209</sup>

While this line of argument was not expressly adopted by the Court and its ruling depended instead on the comparator issue, Mason argues that the Belgian measure in *Kerckhaert* may nevertheless have violated the free movement of capital through the subjection of cross-border dividends to greater overall tax than domestic dividends.<sup>210</sup> Unlike the analysis in AG Geelhoed’s opinion which drew conclusions based on the “facts of the present case” and thus relied specifically on the measures of Belgium and France, Mason argues that the Belgian measure could have been evaluated in light of other, hypothetical measures.<sup>211</sup> She stresses that because the argument that the Belgian measure was discriminatory depended on Belgium’s failure to credit foreign withholding taxes,<sup>212</sup> the Court could have evaluated the Belgian measure’s potential treatment of a cross-border dividend distributed not from France but from another Member State which did *not* grant imputation credits to foreign shareholders.<sup>213</sup> In fact, Mason argues, a situation where a source-Member State refuses to issue imputation credits actually results in a situation where a Belgian resident taxpayer’s foreign-sourced dividends are subjected to significantly greater taxation than purely internal dividends.<sup>214</sup> Seemingly, arguments such as Mason’s above may have impelled the Court to limit its ruling to an evaluation of comparators within the ambit of the non-discrimination test. Moreover, had the

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<sup>206</sup> See Patrick Smet & Hannes Laloo, *ECJ to Rule on Taxation of Inbound Dividends in Belgium*, 45 EUR. TAX’N 158 (2005).

<sup>207</sup> See Mason (n 93), pp 1296-97; Kofler & Mason (n 165), at 75.

<sup>208</sup> Kofler & Mason (n 165), at 75; *Kerckhaert & Morres* (n 22), Opinion of AG Geelhoed, para 25.

<sup>209</sup> See Mason (n 93), pp 1296; *Kerckhaert & Morres* (n 22), Opinion of AG Geelhoed, para 27.

<sup>210</sup> See Mason (n 93), pp 1296-97.

<sup>211</sup> *Ibid*, at 1297.

<sup>212</sup> *Kerckhaert & Morres* (n 22), para 14.

<sup>213</sup> See Mason (n 93), at 1297.

<sup>214</sup> *Ibid*.

Court pronounced that a finding of discrimination *required* that a direct taxation measure actually cause a net tax disadvantage, this holding would have unnecessarily handcuffed the Court and established an overly narrow concept of tax discrimination.<sup>215</sup>

As mentioned earlier with regard to the language and substance of the Court’s discrimination analysis in *Kerckhaert*, the ruling appears to depend entirely on an assessment of the comparability of the capital movements and/or taxpayers at issue. Relying on the well-established case law stemming from *Schumacker*, the applicants sought to establish that 1) the income derived from their cross-border capital movement was not comparable to that derived from a purely internal situation, and 2) it is discriminatory to impose an identical taxation measure both on income that is yet to be taxed and on income that has already been subject to a withholding tax. As Snell declares, “the argument was entirely credible, as the Court has repeatedly held that the application of the same rule to different situations can be discriminatory”.<sup>216</sup> Further, Snell criticizes the Court’s stated reasoning as to the comparator issue in that:

The Court simply asserts that the position of the shareholders is not necessarily altered in the meaning of the earlier case law by the fact that the income has already been taxed in another Member State. This is an entirely inadequate response. In fact, it does not deserve to be called reasoning at all, as the Court does not offer any reasons, but simply lays down a conclusion without explaining how it arrived at it.<sup>217</sup>

While an array of explanations has been posited to explain the Court’s ruling in this case, a recurring consideration is that the Court is cautious to encroach on the autonomy of the Member States in the area of direct taxation. Strongly supporting this opinion, for example, are the statements of AG Geelhoed as to EU legislature’s role as the proper vehicle for intervention in issues of a “systematic nature” or “inherent fiscal-economic policy”.<sup>218</sup>

However, the likelihood of political sensitivity cannot be said to be a legal basis which inspired the Court’s cautious approach to juridical double taxation in *Kerckhaert*.<sup>219</sup> In fact, the

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<sup>215</sup> Ibid.

<sup>216</sup> Snell (n 64), at 362.

<sup>217</sup> Ibid.

<sup>218</sup> See note 58 and the accompanying text.

<sup>219</sup> See Snell (n 64), pp 356-57.

ECJ's stated reason for caution was that EU law, "in its current state", lacked "any general criteria for the attribution of competence between the Member States in relation to the elimination of double taxation".<sup>220</sup> In other words, the Court claimed that the free movement of capital could not be applied broadly to juridical double taxation unless the EU legislature were to develop binding "guidelines" (e.g., a directive) for the allocation of taxing jurisdiction among the Member States.<sup>221</sup> Indeed, the Court in *Kerckhaert* proceeded to refer to the very limited number of harmonization measures that had actually been adopted at the EU level with regard to the elimination of double taxation.<sup>222</sup> The then-current measures were said to be limited to 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 1990 L 225, p. 6), the Convention of 23 July 1990 on the elimination of double taxation in connection with the adjustment of profits of associated enterprises (OJ 1990 L 225, p. 10) and Council Directive 2003/48/EC of 3 June 2003 on taxation of savings income in the form of interest payments (OJ 2003 L 157, p. 38).<sup>223</sup> Still, the ECJ's implication that its ruling was tied to a lack of harmonizing legislation fails to recognize that in a number of its most seminal direct taxation cases "the Court did not hesitate to divide tax jurisdiction among the Member States, despite the absence of Community guidelines".<sup>224</sup> Specifically, Kofler and Mason stress that the Court imposed its "own priority rules" as to tax allocation among the Member States "in the areas of personal tax benefits, cross-border loss utilization, double utilization of depreciation, indirect taxation, and social security".<sup>225</sup> Thus, the ECJ's self-imposed limited competence to effect new priority rules as to juridical double taxation can hardly be considered an inevitable result. Either way, the Court's ruling in *Kerckhaert* made clear its unwillingness to establish priority rules within the ambit of juridical double taxation. Further, despite the dubiousness of the delineation between discrimination and disparity in *Kerckhaert*, the ruling solidified the "new trend"<sup>226</sup> in which the ECJ's more lenient treatment of "mere disparities" appears to mask the Court's hesitancy to

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<sup>220</sup> *Kerckhaert & Morres* (n 22), para 22.

<sup>221</sup> *Ibid*; Kofler & Mason (n 165), at 80.

<sup>222</sup> *Kerckhaert & Morres* (n 22), para 22.

<sup>223</sup> *Ibid*.

<sup>224</sup> Kofler & Mason (n 165), at 80.

<sup>225</sup> *Ibid*, citing to, respectively, *Schumacker* (n 66), *Marks & Spencer* (n 82), para 47, Case C-470/04 *N. v. Inspecteur van de Belastingdienst Oost* [2006] ECR. I-7409, para 54, *Gaston Schul* (n 201), and Case C-336/98 *Sehrer* [2000] ECR I-4585.

<sup>226</sup> See Snell (n 22), at 562.

utilize negative integration where tax integration should instead be adopted by the Community legislature.<sup>227</sup>

## **PART V – POST-KERCKHAERT PROSPECTS FOR THE RELIEF OF DOUBLE TAXATION IN CROSS-BORDER ECONOMIC ACTIVITY**

### **1. TAX COORDINATION VERSUS TAX HARMONIZATION**

Based on the above analysis of *Kerckhaert*, there at least appears to be an apprehensive consensus that the ECJ cannot and should not utilize negative integration to condemn “non-discriminatory” / “merely disparate” direct taxation measures even if said measures might result in juridical double taxation; and, juridical double taxation as an inevitable result of the concurrent direct taxation measures can only be remedied by democratically-chosen, decision-making bodies such as the Council and the European Parliament.<sup>228</sup> Still, while extensive harmonization or uniformity has been agreed to at the EU level with regard to indirect taxation, a relatively limited amount of secondary EU law is capable of affecting national sovereignty in the area of direct taxation.<sup>229</sup> In fact, as Kofler and Tenore explain, “[h]armonization in the field of direct taxation is still limited to some directives confined to discrete areas of particular relevance to cross-border situations”.<sup>230</sup> Through Article 115 TFEU, directives in the field of direct taxation *can* be adopted by unanimous vote for the approximation of such laws, regulations, or administrative provisions of the Member States as directly affect the establishment or functioning of the internal market.<sup>231</sup> Nevertheless, the requirement of unanimity in the Council, coupled with Member State interest in maintaining direct taxation sovereignty, clearly encourages deadlock within the legislative process.<sup>232</sup> Further, the directives and other pieces of secondary law

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<sup>227</sup> See, e.g., Case C-298/05 *Columbus Container Services* [2007] ECR I-10451, paras 43-44, 51.

<sup>228</sup> See Eric C.C.M. Kemmeren, ‘Sources of EU Law for European Tax Integration: Well-Known and Alternative Legal Instruments’ in D. Weber (ed), *Traditional and Alternative Routes to European Tax Integration* (IBFD, 2010), at 38.

<sup>229</sup> *Ibid.*

<sup>230</sup> Georg Kofler and Mario Tenore, ‘Fundamental Freedoms and Directives in the Area of Direct Taxation’ in D. Weber (ed), *Traditional and Alternative Routes to European Tax Integration* (IBFD, 2010), at 322.

<sup>231</sup> Article 115 TFEU

<sup>232</sup> Kofler and Tenore (n 230), at 323.

actually capable of passing muster within the legislative framework of the EU are often lacking in effectiveness relative to their stated purposes, scope, or force. Kofler and Tenore state:

[D]irectives in the direct tax area are the—almost inevitably imperfect—result of compromise between the Member States; [and,] as a consequence of this bargaining process, their respective objective and subjective scopes are limited, they grant general options to Member States, and they even contain express permissions for specific Member States to deviate from the directive’s provisions to take into account budgetary concerns.<sup>233</sup>

Thus, with regard to a directive, regulation, or other form of positive integration capable of harmonizing the treatment of cross-border economic activity so as to eliminate economic or juridical double taxation, the prospect of effective legislation is highly uncertain, at best.

Still, as Kemmeren stresses, while the integration of the Member States’ tax systems is a prerequisite for the realization of an actual internal market, European-wide harmonization of all taxes is neither feasible nor necessary.<sup>234</sup> Rather, he states that a “sufficient level of coordination may be adequate” to remove cross-border tax obstacles that disrupt the internal market.<sup>235</sup> In fact, Kemmeren’s line of argument parallels AG Geelhoed’s observation in *ACT Group Litigation* that net tax disadvantages due to the concurrent taxation measures of multiple Member States would remain inevitable in cross-border economic activity “even if national tax systems were exactly the same in design and content”.<sup>236</sup> Kofler and Mason have expounded upon this observation and stated directly that double taxation is not a problem that can be cured by harmonization of the Member States’ tax laws. Rather, they explain:

Unlike many tax problems in the European Union, double taxation does not arise simply because Member State tax systems are different from each other. Double taxation would persist even if all Member States had *exactly the same* tax laws because double taxation arises from the simultaneous assertion of source taxing rights by the source country and residence taxing rights by the residence country.<sup>237</sup>

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<sup>233</sup> Ibid.

<sup>234</sup> Kemmeren (n 228), at 29.

<sup>235</sup> Ibid.

<sup>236</sup> *Test Claimants in Class IV of the ACT Group Litigation v. Comm’rs of Inland Revenue* (n 58), Opinion of AG Geelhoed, para 48. See also notes 95-103 and the accompanying text.

<sup>237</sup> Kofler & Mason (n 165), at 68.



Again, aside from a few harmonizing directives, the coordination of concurrent taxation measures so as to avoid double taxation has been conducted almost exclusively by means of self-imposed unilateral limitations on jurisdiction initiated by the Member States as well as by DTCs. To avoid negative scrutiny from the ECJ, the direct taxation measures of the Member States must simply be non-discriminatory. Thus, in that Member States' independent techniques to coordinate concurrent taxation do not solve *all* of the double taxation problems which indeed arise in practice, both economic as well as juridical double taxation continue to affect the cross-border economic activity of both individuals and companies.<sup>238</sup>

Clearly, the ECJ has placed the onus on the Member States to resolve the issue of double taxation affecting cross-border economic activity. With regard to the means by which EU-wide tax integration is capable of being realized, Kemmeren stresses 1) negative integration, 2) positive integration, and 3) tax competition.<sup>239</sup> The possibility of negative integration within the ambit of double taxation is, quite simply, limited by the ECJ's ruling in *Kerckhaert* (as well as subsequent case law) and the Court's refusal to remove disparities which manifest as obstacles to cross-border economic activity. Similarly, the possibility of positive integration is limited both by the Member States' lack of willingness to subject their national tax autonomies to EU harmonization measures as well as the general ineffectiveness of direct taxation directives and other legislation capable of clearing the unanimity hurdle. Differently though, with regard to tax competition, Kemmeren cites to notable successes such as both Germany (2001) and the United Kingdom (2009) switching from an imputation system to a participation exemption so as to have their tax systems coordinated with other Member States.<sup>240</sup> However, tax competition obviously can have the opposite effect of coordination where Member States engage in "adversarial" competition and, for example, a Member State's tax system (e.g., low corporate tax rate) is purposely designed with the dual intentions of attracting foreign business as well as disadvantaging the tax revenues of other Member States.<sup>241</sup> Further, tax competition is a disjointed, time-consuming process with little to no guarantee that Member States will actually coordinate their tax systems for the betterment of the internal market. Indeed, none of the above

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<sup>238</sup> Daniel Gutmann, 'How to avoid Double Taxation in the European Union?' in I. Richelle, W. Schön, E. Traversa (eds), *Allocating Taxing Powers within the European Union* (Springer Berlin Heidelberg, 2013), at 63.

<sup>239</sup> Kemmeren (n 228), at 35.

<sup>240</sup> *Ibid*, at 36.

<sup>241</sup> *Ibid*, at 35.

means of tax integration appears ideally suitable or capable of assuring the coordination of concurrent taxation measures so as to eliminate double taxation. Additionally, none of these means appear capable of satisfying the time-sensitive urgency repeatedly expressed by the EU with regard to the removal of tax obstacles to cross-border VC investments.<sup>242</sup>

## **2. ALTERNATIVE INVESTMENT FUND MANAGERS DIRECTIVE (AIFMD) & EUROPEAN VENTURE CAPITAL FUNDS REGULATION (EuVECA)**

Even within the ambit of directives not pertaining to the direct taxation sovereignty of the Member States, highly compromised legislation with watered-down effectiveness is, generally, not uncommon. Recent products of the EU legislative process are the Alternative Investment Fund Managers Directive (AIFMD)<sup>243</sup> and the European Venture Capital Funds Regulation (EuVECA Regulation).<sup>244</sup> The EuVECA Regulation took effect as a complementary piece of legislation and to coincide with the implementation of the AIFMD on July 22, 2013. The AIFMD, like the Dodd-Frank Act in the United States, was developed under the premise that a uniform and comprehensive regulatory framework is necessary to ensure effective monitoring and oversight of alternative investment funds (including larger VC funds) in that such funds are capable of exposing markets to “systemic risk”.<sup>245</sup> Concurrently, the AIFMD provides fund managers with a “marketing passport”—or, more accurately, permission to market their funds across the EU—in exchange for subjection to “strict rules on transparency and disclosure, valuation, risk and liquidity management, the use of leverage, remuneration, conflicts of interest, and the acquisition of companies”.<sup>246</sup> However, as with the “venture capital exemption” of the Dodd-Frank Act, the AIFMD exempts certain qualifying VC funds from the need to comply with the compulsory demands of the AIFMD.<sup>247</sup> This exemption is due to the acknowledgment that 1) VC funds typically utilize little to no debt and 2) the size of the VC industry is too small to pose

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<sup>242</sup> See, e.g., Communication from the Commission to the European Parliament, the Council and the European Economic and Social Committee, Double Taxation in the Single Market, COM(2011) 712 final, Brussels, Nov. 11, 2011.

<sup>243</sup> Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers and amending Directives 2003/41/EC and 2009/65/EC and Regulations (EC) No 1060/2009 and (EU) No 1095/2010 (AIFMD), OJ L 174, 1.7.2011.

<sup>244</sup> Regulation (EU) No 345/2013 of the European Parliament and of the Council of 17 April 2013 on European venture capital funds (EuVECA), OJ L 115, 25.4.2013.

<sup>245</sup> Erik P. M. Vermeulen and Diogo Pereira Dias Nunes, ‘*The Evolution and Regulation of Venture Capital Funds*’ (October 17, 2012). Lex Research Topics in Corporate Law & Economics No. 2012-1, at 5.

<sup>246</sup> Ibid.

<sup>247</sup> Ibid.

systemic risk.<sup>248</sup> Thus, while a corresponding marketing passport or the designation as a “European Venture Capital Fund” is available through the EuVECA Regulation, the passport is both entirely voluntary and subject to less onerous rules than the AIFMD.<sup>249</sup> The EuVECA Regulation is applicable on a fund-by-fund basis and the qualifying criteria for the passport reflect and promote many of the industry-standard drivers of a “virtuous venture capital cycle”.<sup>250</sup> For example, to qualify, VC fund managers must be established in the EU with assets under management neither in excess of a €500 million threshold nor considered “leveraged” as defined in the AIFMD.<sup>251</sup> Further, a qualifying VC fund must invest at least 70% of its aggregate capital contributions and uncalled committed capital in SMEs with fewer than 250 employees, annual turnover not exceeding €50 million, and total balance sheet not exceeding €43 million.<sup>252</sup>

Potential benefits of the marketing passport available through the EuVECA Regulation are predicted to entail decreased costs and increased levels of capital for qualifying funds.<sup>253</sup> Said benefits would derive from the removal of the obligation to comply with the myriad national rules (costs) as to marketing funds in differing Member States.<sup>254</sup> Still, in that the AIFMD and EuVECA Regulation are the products of years of debate within the EU institutions between the competing ideas of opposing interest groups, a level of skepticism exists as to the effectiveness of the legislation in promoting a pan-EU VC industry. For example, during the legislative process building-up to the AIFMD and EuVECA Regulation, the European Parliament—based on the opinions of the European Central Bank and the European Economic and Social Committee (EESC)—proved to be much more concerned with the regulation of funds and markets than with whether the proposed legislation “could harmonize venture capital fundraising and, more importantly, spur venture capital investments in emerging growth companies”.<sup>255</sup> Despite the myriad reports,<sup>256</sup> proposals,<sup>257</sup> opinions<sup>258</sup> and the abundance of time and money

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<sup>248</sup> Ibid.

<sup>249</sup> The European Private Equity & Venture Capital Association (EVCA), ‘*The “EuVECA” Essentials*’ (February 2014), at 2.

<sup>250</sup> See notes 1-15 and the accompanying text.

<sup>251</sup> EuVECA Regulation, (n 244) recitals 8 and 23.

<sup>252</sup> Ibid, article 3.

<sup>253</sup> EVCA (n 249), at 2.

<sup>254</sup> Ibid, at 8.

<sup>255</sup> Vermeulen and Pereira Dias Nunes (n 245), at 12.

<sup>256</sup> See, e.g., the Report of the Expert Group on removing tax obstacles to cross-border Venture Capital Investments (n 16).

spent by lawmakers (and policymakers) considering, re-drafting, and finally producing legislation, the unfortunate reality is that the end-product is often counterproductive or simply ineffective.<sup>259</sup> Indeed, despite the strong consensus that a pan-EU VC industry requires particular taxation measures as well as the elimination of tax obstacles such as double taxation,<sup>260</sup> the EuVECA Regulation is almost completely silent on issues of taxation altogether. Recital 5 refers to the Commission Communication of 7 December 2011, entitled “An action plan to improve access to finance for SMEs” and the prospect of the Commission completing its examination of tax obstacles to cross-border venture capital investments in 2012, with a view to presenting solutions in 2013. But, at current, a possible solution has not been presented.

In fact, prior to the EuVECA Regulation taking effect and with regard to its potential effectiveness in driving a pan-EU VC industry, the EESC opined that “the single passport” in no way addresses “the problem of cross-border tax obstacles in venture capital”.<sup>261</sup> Further, the EESC noted that if the Commission failed to address the “main problems” of the VC industry, there may be limited interest in a marketing passport.<sup>262</sup> Still, as to removing tax obstacles from cross-border VC investments, there exists a level of restrained optimism that “the European-wide regulatory approach to venture capital funds could serve as a good starting point for discussions among tax regulators”.<sup>263</sup> According to the European Private Equity & Venture Capital Association (EVCA), the EuVECA Regulation’s significance (i.e., maybe as not *just* a marketing regulation) within the framework of EU secondary legislation has already been evidenced by cross-references to the “European Venture Capital Fund” designation in proposed legislation with an impact on venture capital.<sup>264</sup> Further, EVCA states:

[I]n its recent proposal on reforms to the structure of EU banks the European Commission has proposed an important exemption for venture capital funds, but

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<sup>257</sup> See, e.g., European Commission, Proposal for a Regulation of the European Parliament and the Council on European Venture Capital Funds, COM(2011) 860 final, Brussels, 7-12-2011.

<sup>258</sup> See, e.g., European Economic and Social Committee, Opinion of the EESC on the Proposal for a Regulation of the European Parliament and of the Council on European Venture Capital Funds, 2012/C 191/13, 29 June 2012.

<sup>259</sup> Vermeulen and Pereira Dias Nunes (n 245), at 2.

<sup>260</sup> See notes 16-21 and the accompanying text.

<sup>261</sup> European Economic and Social Committee (n 257), recitals 1.10 and 1.11.

<sup>262</sup> *Ibid*, recital 4.2.

<sup>263</sup> Vermeulen and Pereira Dias Nunes (n 245), at 14.

<sup>264</sup> EVCA (n 249), at 8.

only if they have the EuVECA designation. If this is accepted by the European Parliament and Council of Ministers this could become a powerful precedent.<sup>265</sup>

Accordingly, if the EuVECA designation is able to develop further into a distinct and widely accepted asset class or “fund vehicle” that—as a driver of EU innovation policy—is often exempted from EU-wide economic and financial regulation such as the AIFMD, new legislation to eliminate cross-border tax obstacles for that same fund vehicle hardly seems improbable. For example, it does not seem far-fetched for the EU to develop harmonizing—or at least coordinating—measures to eliminate uncertainty as to whether the economic activities of a fund manager who has obtained the EuVECA designation will be deemed to have created a permanent establishment in a Member State.<sup>266</sup> Still, clearly, in that “the principles of subsidiarity and proportionality...put severe limitations on the regulatory competences of European policymakers, [said principles] are likely to prevent a quick and effective solution to the cross-border tax issues”.<sup>267</sup>

## CONCLUSION

The Lisbon Strategy set forth in 2001 entailed the ambitious goal for the EU to become the most competitive and dynamic knowledge-based economy in the world—an internal market capable of sustainable growth with more and better jobs. After a decade of myriad programs and initiatives, EU institutions realized that their goals were still very much out of reach and—in particular—that policies and efforts to support innovation achieved minimal success.<sup>268</sup> Thus, as a primary component of the EU’s new EU2020 strategy, said strategy was endowed with a dedicated flagship initiative entitled “Innovation Union”. This initiative has led to “a new generation of even more ambitious policies, which seem likely to lead to an increase in the already egregious levels of public spending”.<sup>269</sup> Further, as Granieri and Renda explain, “the overall impression gained from an analysis of the recent developments in EU innovation policy

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<sup>265</sup> Ibid.

<sup>266</sup> See notes 18-21 and the accompanying text.

<sup>267</sup> Vermeulen and Pereira Dias Nunes (n 245), pp 14-15.

<sup>268</sup> Granieri and Renda (n 1), at 114.

<sup>269</sup> Ibid, at 115.

is that of a labyrinth, in which finding the right direction becomes almost impossible”.<sup>270</sup> And, regardless of the best of intentions in their design and implementation, these new innovation initiatives appear destined to continue to be “constrained, if not frustrated, by the lack of EU competence on issues that still pertain to national governments”.<sup>271</sup>

While many day-to-day pronouncements from Silicon Valley leaders stress the libertarian view that government intervention is simply an ineffective means of stimulating innovation, Lerner stresses that the long history of the VC-industry evidences that “the government’s catalyzing role was critical in stimulating the growth” of entrepreneurial ideas, emerging growth ventures, and start-ups.<sup>272</sup> Further, Lerner makes clear:

Since the 2008–09 global financial crisis, interest among policy makers in promoting innovative, high-potential ventures has exploded. The emerging great hubs of entrepreneurial activity—like Bangalore, Dubai, Shanghai, Silicon Valley, Singapore, and Tel Aviv—bear the unmistakable stamp of the public sector. Enlightened government intervention played a key role in each region’s emergence. But for each effective government intervention, dozens, even hundreds, disappointed, with substantial public spending bearing no fruit.<sup>273</sup>

In fact, in light of the strict constraints of the subsidiarity principle on the competence of the EU in the promotion of innovation, one certainly cannot fault the EU for a lack of effort to promote innovative SMEs. While Granieri and Renda describe the EU’s measures to provide financing to SMEs as “a quagmire” in their administration,<sup>274</sup> the premise of *passively* matching or guaranteeing private investment in innovation can hardly be called baseless.<sup>275</sup> There is a strong consensus that government grants or loans that parallel private investment can drive innovation as long as the government does not attempt *actively* to “choose the winners” and take on the role of the VC fund manager as a “highly incentivized financial intermediary”.<sup>276</sup> And, indeed, the EU has aggressively taken on the role of passive investor through the European Investment Bank in providing guarantees and securitizations.<sup>277</sup> Nevertheless, due to the complexities of

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<sup>270</sup> Ibid, at 116.

<sup>271</sup> Ibid, at 115.

<sup>272</sup> Lerner (n 4), at 4.

<sup>273</sup> Ibid, at 1.

<sup>274</sup> Granieri and Renda (n 1), at 103.

<sup>275</sup> Gilson (n 8), pp 1094-1101.

<sup>276</sup> Ibid.

<sup>277</sup> Granieri and Renda (n 1), pp 103-04.

supranational coordination and governance of these measures, the relative success and continued feasibility of said measures are currently uncertain.<sup>278</sup>

Despite the EU's best efforts and repeatedly demonstrating its awareness of the VC industry's role as the essential link between finance and innovation, the EU's fragmented internal market presents very real issues which frustrate the economies of scale necessary to promote pan-EU VC investment and fundraising.<sup>279</sup> Primary among these issues is the lack of integration between the autonomous taxation systems of the differing Member States and the fact that said systems are not yet coordinated sufficiently to avoid incidents of double taxation in cross-border VC investments. Neither the EU's secondary legislation nor the ECJ's case law currently evidences a willingness to wield its competence to resolve this lack of tax integration / coordination. Again, unless a Member State taxation measure is discriminatory, the ECJ's case law at the intersection of the free movement of capital and national direct taxation measures holds that double taxation is merely a net tax disadvantage which results from the disparities between differing Member States' tax systems. While the ECJ was presented with the opportunity to rule otherwise in *Kerckhaert*, the Court avoided the controversy of such a ruling in that the EU had failed to establish legislative "guidelines" as to the allocation of taxing jurisdiction among the Member States in cases of double taxation. Like a Member State's request for a preliminary ruling, the Court's ruling in *Kerckhaert* might be interpreted as a request for guidelines so as to enable a different ruling in the future. Either way, harkening back to its traditional role in the development of the free movement of capital, the ECJ in *Kerckhaert* proved to be reluctant to give an answer to a question which raised "issues of a systemic nature". Indeed, the ruling in *Kerckhaert* evidenced the ECJ's longstanding consciousness that its obligation to liberalize capital movements at the intersection of direct taxation is 1) dependent on the Member States' economic and political goals, and 2) first, and foremost, a matter for EU legislators.

The AIFMD and EuVECA Regulation are the latest pieces of legislation which might—or might not—eventually inspire new or amended measures that dare to address the tax obstacles to cross-border VC investment in the EU. Despite the anticipation of yet another report from the

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<sup>278</sup> Ibid.

<sup>279</sup> Ibid, at 70.

Commission on the alleviation of said obstacles, the Commission's competence is limited. In fact, the Commission's competence depends entirely on the collective will(s) of the Member States as manifested within the legislative process of the EU. And, in light of the ECJ's holdings in *Kerckhaert* and subsequent case law, the potential for a robust, EU-wide VC industry will depend on the success of future information exchange and education with regard to VC as an asset class by and amongst the Member States. In that an EU-wide VC market could only benefit the SMEs that drive innovation and the EU economy generally, the Member States can and should actively apply themselves to solving the persistent issue of double taxation.



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